SCANDINAVIAN INSTITUTE OF MARITIME LAW

Eduardo G. Pereira

JOA Special Edition

486

JOA Special Edition

MarIus nr. 486
Sjørettsfondet
Nordisk institutt for sjørett
Universitetet i Oslo

© Sjørettsfondet, 2017

ISSN: 0332-7868

Sjørettsfondet
University of Oslo
Scandinavian Institute of Maritime Law
P.O. box 6706 St. Olavs plass 5
N-0130 Oslo
Norway

Phone: 22 85 96 00
E-post: sjorett-adm@jus.uio.no
Internet: www.jus.uio.no/nifs

Editor: Professor dr. juris Trond Solvang –
e-mail: trond.solvang@jus.uio.no

For subscription and single-copy sale, please see Den norske bokbyen
– The Norwegian Booktown
Internet: http://bokbyen.no/en/shop/
E-mail: post@bokbyen.no

Print: 07 Media AS

Overview over content

Foreword ... 5

Joint Operating Agreement: Operatorship role, options and concerns ... 7
Eduardo G. Pereira and Keith Hall

Joint Operating Agreements ... 71
Christopher Mathews and Eduardo G. Pereira

Transfers of interest in Joint Operating Agreements ... 97
Aina Gómez Picanyol

Foreword

Joint Operating Agreements (JOA) are well known agreements in the upstream sector. They aim to regulate the internal relationship of the consortium (including the conduct of operations, liabilities, costs, among others). This is somewhat different than the host government contract, which regulates the external relationship of the consortium parties with the relevant host government (if applicable) and third parties.

Although several books and papers explore the general framework of a JOA and some of their key provisions, we would like to point out that certain issues could be better explored in further detail. This is exactly the main purposes of this special edition, as it is dedicated to three crucial points inside any JOA: namely, the operatorship, the liabilities, and the transfer of interest.

The first paper explores the background behind the conduct of the operations by one party and why this could pose a concern for non-operators. The traditional role is to elect one party inside the consortium to conduct the operations on behalf of the entire group. But what would happen if the JOA parties decided to implement something different? What would be the consequences of electing an incorporated joint venture instead of an unincorporated joint venture, or if the JOA parties elect something more "exotic" such as a joint operating company within a JOA structure, a dual operator, or even a split of operatorship? These considerations will be dealt in the first paper of our special edition.

Another critical concern for any JOA party is establishing the liabilities of each member. One of the key reasons for any party to sign a JOA is to share risks and costs. Thus, the second paper analyses a recent US case and the consequences for the liabilities of the JOA parties. It turns out that what you agreed in the JOA might not be exactly the same outcome if you have to litigate your JOA and let a judge decide how it will be enforced.

Finally, oil and gas companies tend to sell, buy, and flip assets as part of their core business. New management, low prices of commodities, lack

of cash flow and/or opportunities might influence a company to consider merger and acquisition (M&A) options. Although M&A activities tend to happen with frequency in the upstream sector, the JOA might offer a protection for the existing JOA parties as they might not be keen to be part of a new consortium with third parties. So JOAs tend to offer preferential rights to the existing members as a solution to keep the integrity of the original consortium. The third and last paper in this special edition explains the main options to deal with preferential rights and how this provision could be affected by the petroleum legal regime in the relevant country.

***

We are grateful to MarIus and its editor in chief professor Trond Solvang for granting us the opportunity of having this edition of MarIus dedicated to the topic of JOAs.

Eduardo G. Pereira, co-editor

Joint Operating Agreement: Operatorship role, options and concerns

Eduardo G. Pereira[1] and
Keith Hall[2]

---

1 Professor of energy law at the Externado University of Colombia and a research fellow at the Scandinavian Institute for Maritime Law – University of Oslo (Norway). Dr. Pereira specializes in international petroleum law, contracts, business and regulations. Contact details: egp.portugal@gmail.com.

2 Director of the Mineral Law Institute at Louisiana State University, where he teaches courses on domestic U.S. oil and gas law and international petroleum transactions. Before joining the LSU faculty, he practiced law in the U.S. for sixteen years. His email address is keith.hall@law.lsu.edu.

Contents

FOREWORD 5

INTRODUCTION 9

1 CHAPTER ONE – BACKGROUND 11

1.1 The concerns of Non-Operators 14

1.2 What is the main concern with the operatorship clause? 17

2 CHAPTER TWO: PERSPECTIVES BETWEEN INCORPORATED AND UNINCORPORATED JOINT VENTURE 24

2.1 Incorporated forms 25

2.2 Potential Advantages 27

2.3 Reasons Why Parties Might Choose Not to Use the Corporate Form 30

2.4 Unincorporated associations 40

3 CHAPTER THREE: ALTERNATIVES TO ADJUST A JOA MODEL FORM 52

3.1 Split of operatorship 53

3.2 Co-Operatorship/Dual Operatorship 54

3.3 Joint Operating Company 55

3.4 Third party operator 56

3.5 Other practical examples 62

4 CONCLUSION 65

Introduction

Any Joint Operating Agreement (JOA) requires an operator to conduct the operations on the behalf of the Joint Venture (JV) or consortium. The most common approach in the petroleum industry is to elect one party of the consortium as the Operator. The Operator will be leading the consortium to conduct the operations by (i) hiring any service required to perform the joint operations, (ii) proposing the work to be done internally for the Non-Operators approval though the appropriate mechanisms and committees (if applicable), (iii) representing the consortium towards the government and third parties, (iv) requesting the financial resources from the Non-Operators and itself through cash calls or bills. This is efficient because it allows one party to conduct and manage operations for the consortium, but it also causes Non-Operators concern because they share in the risks and rewards of operations, but they lack day-to-day control. Consequently, Non– Operators are eager for some method to provide input, exercise oversight, and gain some level of control, with a goal of ensuring that operations are conducted diligently, efficiently, and in the best interests of the JV. [3]

Often, therefore, JOAs contain provisions to give the Non – Operators some level of input and control. For example, some JOAs establish operating committees and subcommittees that have certain authority. Such provisions give the Non-Operators some oversight and control, but do not eliminate the imbalance in the role and perspectives between Operator and Non-Operator as the Operator is leading and representing the consortium towards the government and third parties as well as internally for the preparation and proposition of the work and actions

[3] See the following books authored, co-authored or edited by Eduardo G. Pereira on JOAs: *Joint Operating Agreements: Controlling risks to the Non-operator* (globe law and business, 2013), *Joint Operating Agreements: Mitigating Operational and Contractual Risks in Exclusive Operation* (globe law and business, 2013), *Joint Operating Agreements: Challenges and Concerns from Civil Law Jurisdictions (Kluwer International, October 2015), Accounting Procedures on Joint Operating Agreements: An International Perspective* (globe law and business*, 2016).*

to be done. Thus, the Operator is commonly in a better and dominant position to determine the future of the said consortium. Accordingly, such provisions do not fully address the Non-Operators' concerns that arise from the fact that commonly the Operator leads and performs nearly all activities of the consortium (including the sole risk in most cases) and quite often has the final and sometimes sole say in the conduct of joint operations, with Non-Operators having much more limited opportunities to directly participate in the joint operations.

But the imbalance in roles and perspectives could be minimised or eventually completed removed if the JOA parties opt for a different type of operatorship. Typically the JOA parties elect one member of the consortium to become the Operator at "no gain no loss" principle. But what happen if the JOA parties elect a third party Operator, create a joint operating company, split the operatorship, create a dual operatorship, or conduct operations in some other way on the behalf of the consortium? Would all of these options (with regards to the replacement of the traditional selection of one party Operator) eliminate the different roles and perspectives between the Operator and Non-Operators in the JOA? Would these alternatives for the operatorship provision create new liabilities and further thoughts for the JOA parties' consideration?

This paper will analyse alternative options available for the JOA parties to minimize the excessive power given to one party to conduct the operations on the behalf of the consortium and possible concerns and risks that each option could bring to the said consortium.

1 Chapter one – Background

Any JOA has two types of parties: The Operator and Non-Operators.[4] The Operator is the leader of the *consortium*,[5] as this is the person responsible for conducting the daily operations in the name of the consortium.[6]

The majority of the duties of any JOA are placed on the Operator, including duties for dealing with the administration of the day-to-day activities of the JV. The Operator is usually the party with the highest level of participation and interest in the enterprise, and sometimes it will have the best financial and technical resources to deal with such duties. The Non-Operators tend to retain a smaller working interest in the JV (at least individually), and often they have fewer financial and technical resources than the Operator. The Non-Operators' situation is similar to that of minority shareholders, as they too, have less say in the

[4] The Operator is commonly a party of the JV, but there are existing cases in which the role of the Operator is given to a contracted Operator or even a company in which the JOA parties are the shareholders. For further information see: Peter Roberts, *Joint Operating Agreements: A Practical Guide* (Globe Law Business, London 2010) 89–93, Sandy Shaw, ´Joint Operating Agreements` in Martyn R. David, *Upstream Oil and Gas Agreements* (Sweet and Maxwell, London 1996) 17.

[5] It is important to note that usually, the Operator is approved by the Host Government who issued the petroleum title, as the Host Government is keen to control the person who will conduct the operations of the consortium. In this context, any modification of the Operator shall also be approved by the Host Government. See: Model Clauses 40, 42 and 42 of the Petroleum Licensing (Production) (Seaward Areas) Regulations 2008.

[6] See: Chavez Gonvala, ´Upstream joint ventures – bidding and operating agreements` in Geoffrey Picton-Tubervill (ed.), *Oil and Gas: A practical handbook* (Globe Law and Business, London 2009) 46, Claude Duval and others, *International Petroleum and Exploration Agreements: Legal, Economic & Policy Aspects* (2ndedn Barrows, New York 2009) 289–291, Anthony Jennings, *Oil and Gas Exploration Contracts* (2ndedn Sweet & Maxwell, London 2008) 24, Michael P. G. Taylor, Sally M. Tyne, *Taylor and Winsor on Joint Operating Agreements* (2ndedn Longman, London 1992) 1–5,Bernard Taverne, *An introduction to the regulation of the petroleum industry: Law, Contracts and Conventions* (Graham &Trotman, London 1994) 135–136, Peter N. Swan, *Ocean Oil and Gas Drilling & The Law* (Oceana, 1979 New York) 65–69, Chris Thorpe, *Fundamentals of Upstream Petroleum Agreements* (CP Thorpe, UK 2008) 123–126,Hugh Dundas, ´Joint Operating Agreements: An Introduction` (1994 Summer Programme: UK Oil and Gas Law, CPMLP 09/09, 1994) 4–5.

conduct of the company's operations. However, they still have shares in the company, along with their own particular views of the company's operations.[7] Thus, it is necessary to understand the needs and perspectives of Non-Operators, in order to establish an efficient, reasonable and fair agreement.[8] If Non-Operators' perspectives are completely ignored, it is extremely hard to create a balanced instrument, and consequently critical problems might arise and possibly jeopardise the existence of the *consortium*, as the cooperation of all its participants are required to establish a successful enterprise. It is also important to note the fact that the JOA is usually in force for the whole duration of the License (or other type of consent, permission or concession depending on the petroleum legal regime in place) which can last up to thirty years or more.[9] In some

---

7 Because of such similarity this research will provide (whenever suitable) few comments about the minority shareholders situation. However, it is outside the scope of the present research to compare and fully analyse the context of minority shareholders. For further information see: F. Hodge O´neal, *Squeeze-Outs"of Minority Shareholders, Expulsion or Oppression of Business Associates* (Callaghan & Company, Chicago 1975), Victor Joffe QC and others, *Minority Shareholders: Law, Practice, and Procedure* (3rd edn OUP, Oxford 2008), AIJA Law Library, *Protection of Minority Shareholders* (Wolters Kluwer, London 1997), A. J. Boyle, *Minority Shareholfer´s Remedies* (CUP, Cambridge 2002), Robin Hollington Q.C., *Minority Shareholders´right´s* (3rd edn Sweet & Maxwell, London 1999), Jacques Cory, *Business Ethics, The Ethical Revolution of Minority Shareholders* (Springer, Haifa 2001), Sylvain Dubois, *Corporate Litigation as a Device to Protect Minority Shareholders, France, England and Wales: A Comparative Analysis* (VDM, Berlin 2010), Daniel Szentkuti, *Minority Shareholder Protection, Germany, France and the United Kingdom: A Comparative Overview* (VDM, Berlin 2008), Marija Bartl, *Squeeze Out: How Much Protection for Minority Shareholders? Comparative Constitutional Analysis of the Czech Regulation of Squeeze Out* (Lambert Academic Publishing, Berlin 2010), Rita Szudoczky, *Takeover Regulations and Protection of Minority Shareholders: A Comparison between the European and US Approach* (Lambert Academic Publishing, Berlin 2008).

8 It is common to analyze a JOA under the Operator perspective, but it is important to note that few authors also recognized the importance of Non-Operators such as Jonh B. B. Bullough, ´The Norwegian Experience – The Role of a Non-Operator` (1996) 11 Oil and Gas Finance & Accounting and Peter Roberts, *Joint Operating Agreements: A Practical Guide* (Globe Law Business, London 2010) 244–245.

9 *´Joint operating agreements are designed to last for the life of the field, during exploration, appraisal and development. Amendments, thought not rare, are less common than might be expected for a document with a 30-year lifespan.`* Charez Golvala, ´Upstream joint ventures – bidding and operating agreements` in Geoffrey Picton-Turbervill (ed.), *Oil and Gas: A practical handbook* (Global Law and Business, London 2009) 45–46.

cases, a provision which appears to be favourable to a party in the early stages might turn out to be unfavourable to the same party later in the life of the JOA. Consequently, balanced terms should offer reasonable terms for all the contracting parties from the beginning until the end of the JOA's life.

This topic might be of great value to countries that have reached the stage of being a mature province (e.g. the UK and Norway),[10] as large International Oil Companies (IOCs) are likely to remove their investments from such areas and prefer to invest elsewhere with greater rewards. These IOCs are being replaced by small or medium independent companies, commonly with less experience and lacking the financial resources to operate in the Exploration and Production (E&P) phases.[11] In other words, the traditional context, in which a JOA is based on a strong, dominant Operator, is significantly changing, and some JVs are composed of parties in a similar position (the parties are more equal). Some oil and gas regions have already reached maturity and the trends mentioned will grow even though new technology might extend the life of current fields in these regions.[12] This new scenario requires better-balanced agreements to govern joint operations. Considering these facts, it is important to understand the perspectives and views of Non-Operators, as this would have great value for today's JOAs (which have a stronger Operator), but

---

10 *'The UK government has for some time recognised that the maturing provinces of the North Sea, coupled with more recent smaller developments, have created a need for a change in its approach to licensing and taxation.'* Stephen Dow, ´The 20th Round Standard Form Joint Operating Agreement` (2003) 1 OGEL.

11 *'Twenty years ago Southeast Asia was a hotbed of international exploration activity, and Indonesia represented fully half of that activity. Indonesia still represents a large share of the activity in the region but the region is not the focus of attention it was back then. Southeast Asia has moved from center stage. Furthermore, SE Asia has matured significantly in the past two decades. So have other regions of course (...).'* Daniel Johnston, 'Contract Terms Worldwide: A Case for New Frameworks' (2004) 2 (3) OGEL.

12 *'The basins of this planet have matured perhaps more quickly than many of us anticipated.'* Daniel Johnston, Contract Terms Worldwide: A Case for New Frameworks (2004) 2 (3) OGEL.

it will have even more value for future JOAs where the parties are in a more equal position.[13]

1.1 The concerns of Non-Operators

As previously described, the Operator is commonly the party with the largest interest in the JV, as it might be argued that the Operator needs to retain robust financial and technical resources to conduct such operations. In this sense, the current agreements secure a dominant position for one party, as extensive rights are given to and duties placed on the Operator and agreements also restrict the number of parties that would be able to exercise such a role.

On the other hand, the Non-Operators are the remaining parties of the JV. The Non-Operators are not going to conduct the operations but their participation is restricted to financial contributions to enable the performance of such operations and sometimes in operating committees.[14] However, beyond such financial contributions the role of Non-Op-

---

13 It is important to note that might exist scenarios where Operators are not strong or even the dominant party of the enterprise. For example independent companies appear more commonly in onshore operations but this scenario is not usual in offshore operations, as the risks and costs are extremely more significant. However, generally this is not an ordinary situation, as the Operator is in a better position to control the joint operations. Consequently, major companies prefer to secure their assets in an efficient operation conducted by them. Nevertheless, some huge developments will require the participation of several major companies together which will also lead to the same point where the parties are in a position of equals.

14 See: Terence Daintith, Geoffrey Willoughby (eds), Adrian Hill, *United Kingdom Oil & Gas Law* (3rdedn Sweet & Maxwell, London 2009) 1140, Gerard M. D. Bean, *Fiduciary Obligations and Joint Ventures: The Collaborative Fiduciary Relationship* (OPU, Oxford 1995) 14–15, Kenneth Charles Mildwaters, *Joint Operating Agreements, A Consideration of Legal Aspects Relevant to Joint Operating Agreements used in Great Britain and Australia by Participants thereto to Regulate the Joint Undertaking of Exploration for Petroleum in Offshore Areas with Particular Reference to their Rights and Duties* (PhD Thesis presented to the University of Dundee, 1990) 427, John Wilkinson, *Introduction to Oil & Gas Joint Ventures: Volume one, United Kingdom Continental Shelf* (OPL, Ledbury 1997) 40, Ernest E. Smith and others, *International Petroleum Transactions* (3rdedn RMMLF, Westminster 2010) 538–544, Peter Roberts, *Joint Operating Agreements: A Practical Guide* (Globe Law Business, London 2010) 79–87, Scott Styles, ´Joint Operating Agreements` in John Paterson, Greg Gordon (eds), *Oil and Gas Law: Current Practice and Emerging Trends* (DUP, Dundee 2007) 288.

erators is far less certain as some JOA models strengthen their position by increasing their participation and control of the Joint Operations (specially through operating committees and sub-committees and the related approvals);[15] but others arguably position the Non-Operators as mere observers or investors of the same Joint Operations.[16] Nevertheless, it is possible to argue that no JOA provides a direct and profound participation and collaboration in operations for the Non-Operators as the title of the models suggest.

Consequently, the imbalance between the strength of the parties also affects the role of the parties in the JOA, as the consortium is focused on only one side of the consortium, namely the sole operatorship by the Operator.

Therefore it is easy to understand the reasons for the different views and perspectives held by these parties, as each one has a different role in the JV. The Operator, as the ´manager` of the JV,[17] desires more power to conduct the joint operations. On the other hand, the Non-Operators, as participants in the JV, desire more control over the joint operations.[18]

Of the differing circumstances and position of the Operator on the one hand and the Non-Operators on the other can lead to tension between the parties and provide grounds for dispute. In other words, it is possible to argue that the most JOAs fail to provide a collaborative agreement which would increase the participation of all parties and at the same would reduce the level of uncertainty and conflicts which affect all JOAs even though a strong control over the operating committee might give a

15 *´´But non-operators are active investors in that they have an active say in the managing of the project through the JOC. The existence of the Opcom is one of the most significant differences between the typical UKCS JOA and US one based on AAPL Form 610*Scott Styles, ´Joint Operating Agreements` in John Paterson, Greg Gordon (eds), *Oil and Gas Law: Current Practice and Emerging Trends* (DUP, Dundee 2007) 286.

16 *´The role of non-operators in the alliance is one of non-operating, non-working, interest owners or, to put it more simply, the role of an investor.`* Scott Styles, ´Joint Operating Agreements` in John Paterson, Greg Gordon (eds), *Oil and Gas Law: Current Practice and Emerging Trends* (DUP, Dundee 2007) 286.

17 Gerard M. D. Bean, *Fiduciary Obligation and Joint Ventures, The Collaborative Fiduciary Relationship* (Clarendon Press, Oxford 1995) 161–175.

18 Sandy Shaw, ´Joint Operating Agreements` in Martyn R. David, *Upstream Oil and Gas Agreements* (Sweet and Maxwell, London 1996) 21–22.

reasonable degree of control for the Non-Operators. Ideally, all parties would participate in the decision-making process.

The JOA is commonly between private parties as this type of agreement relates to the horizontal relationship of the consortium parties.[19] Consequently, the state's participation is limited to certain approvals required to explore and to produce natural resources, as these resources belong to the host government. In other words, the terms of a contractual arrangement, such as a JOA are not usually dictated by the HG, but only to the extent they affect relevant and strategic issues from the governmental perspective.

However, certain jurisdictions (e.g. Norway, Nigeria, Angola, Iran, Brazil and even the UK by past legislation about the BNOC) require and/or allow by law, state participation in some or all oil and gas operations, so it might be compulsory to include a governmental party in the relevant JOA.[20] This participation could occur at an earlier or later stage. If the government desires to participate from the beginning of the operations, it would commonly involve a carry of interest, as the state company would be less likely to share any risk until the production of natural resources. If the government wants to participate at a later stage, (after the exploration phase) it is less likely to involve a carry of interest, as the critical risks occur during the exploration phase, so the NOC would not share the critical risks of the project even though some NOCs can bear risks and costs from the early start of the project.

In principle, the NOC should be treated as a normal party in the JOA, when it decides to join the operations, unless a carry of interest is provided or specific special rights could be given (e.g. preferential rights on transfers in Norway and Angola). But the reality is quite different from such a principle, as the default provision might be far more complicated to enforce against the state company, as it is not willing to lose all of its participation of interest. On the other hand, it could be argued that

[19] Ibid.

[20] See: Rajendra Ramlogan, 'State Participation in Joint Ventures: The Republic of Trinidad and Tobago Experience' (1992) 10 J. Energy & Nat. Resources L. 279–284, Mirian Kene Omalu, Armando Zamora, 'Key Issue in Mining Policy, A Brief Comparative Survey as a Background Study on the Reform of Mining Law' (CEPMLP PAPER NO CP 9/98).

having a state company as a co-venturer is a positive thing as it should be easier to obtain any additional permissions/authorisations/licences related to the oil and gas operations (e.g. environmental consents, access to land, access to infrastructure, etc) and it might reduce the political risks involving assets expropriation.[21]

Therefore, the involvement of a NOC in the JOA might increase the demand for a more balanced agreement as a Non-Operator NOC is less likely to accept being a dormant partner or passive investor (e.g. the last section of this paper is going to provide a practical example on how a NOC might desire to balance the operatorship provision through a cooperative agreement). Equally IOCs might be concerned to have a NOC with strong Operator powers with limited controls.

1.2 What is the main concern with the operatorship clause?

Ideally a JOA should contain balanced provisions which should reflect the concerns of all parties involved: Operator and Non-Operators. It should also allow participation of all parties, as they all share the ownership of the JV. However, this is not usually the case as current JOAs tend to reflect the wishes of one party in the consortium (i.e. the Operator) instead of all parties.[22] JOAs aim to regulate an enterprise that clearly depends on the contribution of all parties, (oil and gas operations often involve extraordinarily large amounts of expenditure over a long time scale)[23] so the question is, why are JOAs not often balanced? The answer for such a question lies in the context and history of oil and gas operations.

[21] For further information see: Peter Roberts, *Joint Operating Agreements: A Practical Guide* (Globe Law Business, London 2010) 49–51.

[22] '*(…) traditionally the perception has been that the Operator has de facto much more to say over the entire project and is best positioned to take the initiative; thus the operator is rewarded with greater power, rather than greater profits.* Scott Styles, ´Joint Operating Agreements` in John Paterson, Greg Gordon (eds), *Oil and Gas Law: Current Practice and Emerging Trends* (DUP, Dundee 2007) 277–278.

[23] Ibid.

The stronger position of the Operator comes from the historical approach contained in the first standard form JOA in 1956, but it still exists in modern operations.[24] It is considered the 'traditional' approach. This fact is clearly recognised by the overall majority of academics and professionals related to oil and gas operations. Traditionally, the oil and gas industry has always assumed there was a need for a strong and dominant Operator, who was supposed to dominate the consortium and determine the pace of the operations[25] As a consequence, the unbalanced relationships did not favour a higher degree of participation by the Non-Operators, but rather resulted in an Operator-biased document.[26] So the question is, why was it necessary to give one party great authority over the others?

Experts give three reasons for such a stronger party, which can be summarised as: a) Burden, b) Formation, c) Commitment. The first theory is based on the fact that the Operator has several duties to perform and comply with, so it should obtain certain benefits in order to compensate it for such a 'burden'. The second theory is based on the formation of the *consortium*. The theory is that a leader needs a higher level of benefit to encourage him to create and take the lead in a JV. The third theory is the most accepted by experts in this field, which is related to the level of commitment of the Operator. Oil and gas operations involve several risks and costs; therefore, it is very important to maintain a higher level of commitment from the Operator towards the success of the JV. At the same time, the Operator's higher level of commitment reduces the

---

24 Ibid

25 *being operator will allow a party to drive the agenda for performance of the joint operations and to better control the associated activities. This will be a positive outcome where the party-operator is keen to progress the requirements on the concession, but equally the level of control which is vested in the party-operator could be applied negatively where that party-operator has, for its own reasons, any reluctance to do anything other than the bare minimum which is necessary to perform the concession.'* Peter Roberts, *Joint Operating Agreements: A Practical Guide* (Globe Law Business, London 2010) 80.

26 '*(…) traditionally the perception has been that the Operator has de facto much more to say over the entire project and is best positioned to take the initiative; thus the operator is rewarded with greater power, rather than greater profits.*'Scott Styles, ´Joint Operating Agreements` in John Paterson, Greg Gordon (eds), *Oil and Gas Law: Current Practice and Emerging Trends* (DUP, Dundee 2007) 277–278.

risk that the Operator will take the opportunity to make more profit or recover any losses during the negotiation period, which it might if it were a smaller participant.[27]

In addition, often, circumstances require the Operator to pay, in advance, the costs of the operation, which are later reimbursed by the Non-Operators according to their shares.[28] In this sense, a stronger Operator is able to deal more easily with any advance costs which might be required.

The first and second theories are likely to be raised by the Operator during the negotiation period to support its arguments in favour of a

[27] See: Terence Daintith, Geoffrey Willoughby (eds), Adrian Hill, *United Kingdom Oil & Gas Law* (3rd edn Sweet & Maxwell, London 2009) 1140, Gerard M. D. Bean, *Fiduciary Obligations and Joint Ventures: The Collaborative Fiduciary Relationship* (OPU, Oxford 1995) 14–15, Kenneth Charles Mildwaters, *Joint Operating Agreements, A Consideration of Legal Aspects Relevant to Joint Operating Agreements used in Great Britain and Australia by Participants thereto to Regulate the Joint Undertaking of Exploration for Petroleum in Offshore Areas with Particular Reference to their Rights and Duties* (PhD Thesis presented to the University of Dundee, 1990) 427, John Wilkinson, *Introduction to Oil & Gas Joint Ventures: Volume one, United Kingdom Continental Shelf* (OPL, Ledbury 1997) 40, Ernest E. Smith and others, *International Petroleum Transactions* (3rd edn RMMLF, Westminster 2010) 542, Peter Roberts, *Joint Operating Agreements: A Practical Guide* (Globe Law Business, London 2010) 80, Scott Styles, ´Joint Operating Agreements` in John Paterson, Greg Gordon (eds), *Oil and Gas Law: Current Practice and Emerging Trends* (DUP, Dundee 2007) 277–278, Charez Golvala, ´Upstream joint ventures – bidding and operating agreements` in Geoffrey Picton-Tubervill (ed.), *Oil and Gas: A practical handbook* (Globe Law and Business, London 2009) 46, Claude Duval and others, *International Petroleum and Exploration Agreements: Legal, Economic & Policy Aspects* (2nd edn Barrows, New York 2009) 289,Anthony Jennings, *Oil and Gas Exploration Contracts* (2nd edn Sweet & Maxwell, London 2008) 24, Michael P. G. Taylor, Sally M. Tyne, *Taylor and Winsor on Joint Operating Agreements* (2nd edn Longman, London 1992) 2,Bernard Taverne, *An introduction to the regulation of the petroleum industry: Law, Contracts and Conventions* (Graham & Trotman, London 1994) 136, Peter N. Swan, *Ocean Oil and Gas Drilling & The Law* (Oceana, 1979 New York) 65–69, Chris Thorpe, *Fundamentals of Upstream Petroleum Agreements* (CP Thorpe, UK 2008) 127,Hugh Dundas, ´Joint Operating Agreements: An Introduction` (1994 Summer Programme: UK Oil and Gas Law, CPMLP 09/09, 1994) 4–5.

[28] *'The JOA will set up procedures for "cash calls" by the operator to the other participants to advance monies to be used for the joint account. Some JOAs, however, depart from the usual procedure of cash calls, as in the UK Model JOA which provides that the operator shall fund the costs of the joint operations on the behalf of the participants, subject to reimbursement and payment of a financing fee upon receipt of invoices from the operator.'*Claude Duval and others, *International Petroleum and Exploration Agreements: Legal, Economic & Policy Aspects* (2nd edn Barrows, New York 2009) 298.

higher percentage of return ('profits') from the JV.[29] However, the strongest reason for the larger interest retained by the Operator is certainly the third theory which is related to economic reasons. This view is supported by a large variety of scholars such as Gerard Bean, [30] Ernest Smith, [31] Claude Durval[32] and Kenneth Mildwaters.[33]

From a horizontal perspective, (i.e. JOA party to JOA party) there is no doubt that the third theory is the main reason behind the tradition of a strong Operator's position, as it would avoid questions about such a party's motivation to become an Operator, *i.e.,* the possibility to make profit from such a role.

From a vertical perspective (i.e. party to HG), the government might also exercise an important role in determining the larger interest of the Operator, as in some cases the petroleum legal regime will require that the Operator shall retain no less than a certain percentage of interest for the whole duration of the JOA, subject to its removal, if such obligation is not complied with.[34]

It can be seen both Non-Operators and Host Governments sometimes fear that an Operator with a smaller interest might not dedicate the necessary effort and commitment in such operations, so the Operator is likely to be the party with the greatest interest and with the strongest position in the JV.

---

29 Terence Daintith, Geoffrey Willoughby (eds), Adrian Hill, *United Kingdom Oil & Gas Law* (3rd edn Sweet & Maxwell, London 2009) 1140.

30 Gerard M. D. Bean, *Fiduciary Obligations and Joint Ventures: The Collaborative Fiduciary Relationship* (OPU, Oxford 1995) 14–15.

31 Ernest E. Smith and others, *International Petroleum Transactions* (3rd edn RMMLF, Westminster 2010) 542.

32 Claude Duval and others, *International Petroleum and Exploration Agreements: Legal, Economic & Policy Aspects* (2nd edn Barrows, New York 2009) 289.

33 Kenneth Charles Mildwaters, *Joint Operating Agreements, A Consideration of Legal Aspects Relevant to Joint Operating Agreements used in Great Britain and Australia by Participants thereto to Regulate the Joint Undertaking of Exploration for Petroleum in Offshore Areas with Particular Reference to their Rights and Duties* (PhD Thesis presented to the University of Dundee, 1990) 427.

34 Ibid.

It could also be argued that it is the nature of business, that the party who is in the better negotiating position, gets more benefits.[35] In general terms it might be true, but for an oil and gas operation such a scenario might be slightly different. Firstly, the Operator does not desire to bear all the risks and costs of the relevant operation by itself as they could be extremely high. Consequently, the Operator should have "partners" to share the risks and cost involved. Secondly, the Non-Operators are not only part of the JV, but also jointly liable for the operations conducted by the Operator, regarding any third party. Thirdly, oil and gas companies usually have their assets spread out in different investments, so normally no party can realistically conduct all operations alone. In some areas they operate and in others someone else operate those assets. Therefore, it is highly important for the all parties (including the Operator) to maintain certain equilibrium between the role of each party of the consortium, as in the end, it will benefit all of them.

If the parties do not establish a balanced agreement, it might cause some problems.[36] Firstly, the unbalanced provisions might cause uncertainty, as any Non-Operator could seek court protection or relief against unfair provisions of the applicable JOA (e.g. relief against a forfeiture provision). In an extreme case, draconian provisions might not allow the Non-Operators to remain as a party in the agreement, which might jeopardise the whole consortium. If this happens, the Operator has to find another 'partner' and negotiate another JOA and at the same time might even get involved in court litigation with its previous "partners". In other words, the current unbalanced JOAs can cause serious damage to the consortium and also to the Operator itself.

---

[35] *'The greater the number of parties and the bigger the issues, particularly if they are wholly or in part political, the more complex the negotiations tend to be, but even bilateral negotiations on comparatively minor issues can become complicated.'* Professor R. W. Bentham, 'The Negotiation of Agreements' (1987) 5 J. Energy & Nat. Resources L. 134.

[36] *'But at the same time drafting which is ambiguous or over-clever should as a rule be avoided, since although this may solve, or appear to solve, immediate problems it can lead to trouble in the future, and the agreement should, in my view, be the bedrock upon which the parties found their future relationship.'* Professor R. W. Bentham, 'The Negotiation of Agreements' (1987) 5 J. Energy & Nat. Resources L. 139.

It is possible to suggest that the adoption of unbalanced JOAs for modern operations is understandable, because of the dominant position of the Operator, even though it is fairly risky, as previously described. However, it will be less suitable for future operations when more oil and gas regions reach maturity. The mature stage of a region for oil and gas operations is less attractive for major or large companies, as most of the reserves have been produced which leaves only small or medium fields to be explored. In such a scenario, large companies move towards new regions where large reserves are still waiting to be found. Consequently, as major or large companies exit the mature provinces they are replaced by new companies, which are mainly small and medium-sized companies. In this case, the whole paradigm of the JOAs changes radically. The Operator is no longer in a dominant position compared with the Non-Operators but in an equal position. As a consequence, the unbalanced JOA is less likely to be useful in mature areas, as the parties should seek to negotiate another agreement based on equitable grounds. For those reasons, it is crucial to understand the Non-Operators' views of and concerns about a JOA, so it is possible to achieve a balanced agreement which should reflect the views and concerns of all parties involved (Operator and Non-Operators).

The bargaining power of the parties is still unequal and the dominant party is always likely to seek the best outcome for itself. Such a lack of equality in bargaining power is problematic when the smaller party tries to include optional provisions in a model form (especially in the AIPN JOA 2012 Model form). Optional provisions will not be implemented unless they are beneficial to the stronger party.[37]

If the standard form does not provide the right balance between the parties, then it is unlikely that the parties will achieve such a balance as their size and the context will favour the stronger, dominant party, i.e. the Operator. Nevertheless, if the Non-Operators are all large IOCs then they might be able to include more protections and controls over the Operator.

---

[37] P.R. Weems, M. Bolton, ´Highlights of Key Revisions – 2002 AIPN Model Form International Operating Agreement.' 1 OGEL 5 (2003) 32.

The extent of such an imbalance is clearly seen in the roles of the parties in the consortium. Although the agreement refers to 'joint operations,' the reality is quite far from that, as one party will perform and conduct the operations and the others will mainly contribute financially even though in some occasions Non-Operators might have more control through certain mechanisms like operating committee and other approvals inside the JOA. However, as regards the consequences and liabilities of the enterprise it truly is a "Joint Operating Agreement", as all parties are jointly liable for all the operations performed under the petroleum title. In other words, the costs and liabilities are shared, but the conduct of the operations is not. As a matter of fact, the situation for the Non-Operators is even more complicated, as in many cases, they cannot even participate or determine the decisions concerning the operations. For example, this is often the cause under North American JOA model forms, which do not provide for operating committees. In other words, the Non-Operators are in the same situation as mere passengers in public transport. They share the costs of the transport and choose the final destination,, but they cannot determine the route However, for an oil and gas operation, the lack of participation might have severe consequences.

2 Chapter two: Perspectives between incorporated and unincorporated joint venture

Any time that one or more persons own and operate a business, they must make a decision regarding the form that the enterprise will take – for example, whether it will be a sole proprietorship, a corporation, or some sort of unincorporated association, such as a partnership or joint venture. The owners do not necessarily need to make an explicit decision. If they do not make an explicit decision, their actions and the decisions they make regarding the business and their relationship will implicitly control the form of the enterprise. Indeed, even if the parties make an explicit decision regarding the form that they wish the enterprise to take, their actions can be significant to the proper classification of the form of their business because the law sometimes requires certain factors or elements be satisfied in order for a enterprise to be classified under law in a certain way. Thus, the parties' characterization of the form of their business might not correspond with the way that the business would be classified under the law.[38]

If more than one person is an owner of the business enterprise, then by definition the business cannot be a sole proprietorship, though the parties may be able to operate the business in an analogous way. For example, if the parties are co-owners of property, they may be able to use and develop the property as co-owners in indivision, and do so for the purpose of seeking commercial gain, without creating a corporation, partnership, or joint venture. There are various advantages and disadvantages to the different forms of business. This chapter will consider the different

[38] One commentator explained:
Through careful counseling and drafting it is possible to create optimum relationships for clients engaged in oil and gas operations. However, it is not possible to make what is in fact a "cat" into a "dog" by merely labeling it a "dog." If the factual attributes point towards "cat," we have a "cat," not a "dog."
David E. Pierce, *Transactional Evolution of Operating Agreements in the Oil and Gas Industry*, Rocky Mtn. Min. L. Inst. on Oil and Gas Agreements: Joint Operations (2008).

forms that a business enterprise may take, as well as the advantages and disadvantages of each.

2.1 Incorporated forms

There are various types of incorporated entities. One of the main types is the corporation. A corporation is an artificial, juridical person[39] that is owned by one or more shareholders.[40] Another type is the limited liability company, which is an artificial, juridical person that is owned by one or more members.[41] There are other types of incorporated entities which might vary in accordance to the local law (e.g. *sociedad en comandita).*[42] But the most common types are limited liability companies and corporations.

Use of a corporate form to conduct a business has certain advantages.[43] Some of these relate to ease of administration and operation of the business. For example, use of the corporate form facilitates centralization of management and decision making.[44] Further, because the law treats corporations and limited liability companies as persons, a corporation or limited liability company can own and transfer property, enter contracts, and also sue and be sued in its own name.[45] Accordingly, there is no need for each of the co-owners to personally join in each of the many transactions entered by the business or, alternatively, to designate an agent that is empowered to enter each of the transactions on that co-owner's behalf. This greatly

39 *See, e.g.*, La. Civ. Code art. 24 ("A juridical person is an entity to which the law attributes personality, such as a corporation or a partnership."); 31 Laws of Puerto Rico § 101 ("The following are artificial persons … Corporations"); Blume Const., Inc. v. State ex rel. Job Service North Dakota, 872 N.W.2d 313, 316 (N.D. 2015). Under both common law and civil law systems, a corporation constitutes a juridical entity. Harry G. Henn and John R. Alexander, Laws of Corporations § 9 at p. 16 ("corporation is a separate entity in the civil law") and p. 18 ("common law … [applies] … entity theory to the corporation") (West Publishing 3rd ed. 1983).

40 Henn, supra n. 39 § 974 at pp. 130-1.

41 *See, e.g.*, Tex. Bus. Org. Code § 101.001; La. Rev. Stat. 12:1301.

42 *See, e.g.*, People of Puerto Rico v. Russell & Co., S. En. C., 288 U.S. 476, 480–1 (1933).

43 Henn, supra n. 39 § 16 at pp. 50–1.

44 Henn, supra n. 39 § 16 at pp. 50–1.

45 Henn, supra n. 39 § 16 at pp. 50–1 (West Publishing 3rd ed. 1983).

simplifies administration of the business. If a business enters numerous transactions or has many owners (or both), it would be impractical to have every owner join in every transaction. Moreover, in many cases one or more owners likely would object to a transaction that other owners wanted to enter, potentially leading to a deadlock. But when a business operates as an incorporated entity, the entity can act on its own, through employees or other agents, and pursuant to articles of incorporation or organization and by-laws that govern decision making and the entity's organizational structure. Thus, unless the entity's organizing documents provide otherwise, a single owner generally cannot cause a deadlock.

Use of the corporate form can also make transfers of ownership interests easier.[46] Because a shareholder or member simply owns a fraction of the incorporated entity rather than directly owning a fraction of each item of property used in the business, and because the individual shareholders or members generally are not parties to each of the entity's contracts, an owner generally can transfer his interest simply by selling his shares or his membership interest. He or she does not have to sell a fraction of each item of property and make assignments of numerous contracts. Further, the corporate form brings another benefit. Although the general rule is that contracts are freely assignable,[47] the transferor typically remains liable for contractual obligations unless he or she secures a release from the party or parties on the other side of the contract.[48] Because a shareholder or member is not a party to the entity's contracts, he or she generally need not worry about attempting to secure releases from contractual liabilities after he or she has sold his interest.

Indeed, as a general rule, even current shareholders or members are not personally liable for the obligations of the corporation[49] or limited

---

46 Henn, *supra* n. 39 at § 16, pp. 50–1.

47 La. Civ. Code art. 2642; Cloughly v. NBC Bank-Seguin N.A., 773 S.W.2d 652, 655 (Tex. App. 1989, writ denied).

48 Seagull Energy E&P, Inc. v. Eland Energy, Inc., 207 S.W.3d 342, 347 (Tex. 2006); La. Civ. Code art. 1821; Restatement (Second) Contracts § 318.

49 *See, e.g.*, Henn, supra n. 39 § 16 at pp. 50–1 and § 73 at pp. 130–1; N.D. Cent. Code § 10-19.1-69.

liability company.[50] If the entity itself becomes worthless, the shareholder or member can lose whatever investment he made into the entity, but that is generally the worst that can happen.[51] The fact that shareholders and members do not have personal liability for an incorporated entity's obligations is one of the principal benefits of the corporate form.[52]

2.2 Potential Advantages

When multiple parties wish to jointly own an oil and gas license, they typically do not do so through each of them owning a fraction of an incorporated entity that itself owns the license. Instead, the parties typically will each own a direct interest in the license. They choose one of the parties to actually operate the license, and the parties regulate their relationship to one another and with the operator using a JOA. But another option would be for the parties to use the corporate form. They could create a corporation or limited liabilty company, with each of the parties owning a fraction of the entity, and the incorporated entity itself could own and operate the license. Use of the corporate form in this context could have some of the same advantages that the corporate form provides in other contexts. For example, use of the corporate form can limit the liability of the shareholders or members. And given that oil and gas operations can result in large liabilities, this limitation of liability has obvious value.

Further, if the parties create a corporation or limited liability company that they jointly own, and that entity serves as operator, the parties may find it easier to retain a voice in controlling operations than when the parties each directly co-own a fraction of the license and one party

[50] *See, e.g.*, Cal. Corp. Code § 17703.04; Colo. Rev. Stat. § 7-80-705; La. Rev. Stat. 12:1315(A); N.D. Cent. Code 10-32.1-26; N.M. Stat. § 53-19-13; Ohio Rev. Code § 1705.48; 18 Okla. Stat. § 2022; 15 Pa. Consol. Stat. § 8922(a); Tex. Bus. Code § 101.114.

[51] Taszarek v. Lakeview Excavating, Inc., 883 N.W.2d 880, 883 (N.D. 2016); Henn, supra n. 39 § 73 at p. 130.

[52] Hanewald v. Bryan's Inc, 429 N.W.2d 414, 416 (N.D. 1988) ("one of the primary advantages of doing business in the corporate form" is "avoid[ing] personal liability"); Henn, supra n. 39 § 73 at p. 130 ("Limited liability is probably the most attractive feature of the corporation….").

serves as operator. If a jointly-owned entity serves as operator, each party will be a shareholder or member of the entity and probably will have representation on any corporate board of directors. Further, if the parties staff the entity with secondees, then each party that loans secondees to the incorporated entity will have one or more of its own employees on the inside of the operating company. Those employees can then be the party's "eyes and ears" within the operator itself (this can be done with an unincorporated association as well) even though this can also be done within unincorporated joint ventures to certain extent.

In addition, the ease of transferring ownership that is promoted by use of the corporate form can be a benefit with respect to oil and gas interests, just as it is for other types of business and property interests. Moreover, use of the corporate form can have help avoid certain problems relating to transfers of ownership that can arise if parties each directly own fractional interests in a license and the various facilities associated with it, rather than each party owning shares in a corporation that owns the license and associated facilities. One such problem is the possibility that one of the co-owners would seek a partition of ownership. In some jurisdictions, a partition could result in a judicial sale of the entire license and the associated facilities.[53]

Another potential problem is the possibility that a party chooses to sell its interest in a way that results in an individual party owning different fractions of different facilities. Suppose, for example that Party C holds a 40% interest in the license and all facilities associated with it, while Parties A and B each own 30%, and that ten wells have been drilled and are operating under the license. A problem can arise in the following way. Suppose that Party C: (1) sells the entirety of its interest in Wells 1 through 3 to Zulu; (2) sells half of its interest in Wells 4 through 7 to Yankee, while retaining the other half of its interest in those wells; (3) sells the entirety of its interest in Wells 8 through 10 to X-Ray; and finally (4) sells its entire interest (other than the existing wells) in the northern half

[53] *See, e.g.*, La. Rev. Stat. 31:173 (co-owner of an oil and gas lease may compel partition); La. Civ. Code art. 811 (possibility of partition by sale of co-owned item and distribution of proceeds of sale).

of the area covered by the license to Whiskey, while retaining its interest in the southern half. This will result in the following ownership patterns:

	Wells 1–3	*Wells 4–7*	*Wells 8–10*	*Future Wells in the South*	*Future Wells in the North*
A	30%	30%	30%	30%	30%
B	30%	30%	30%	30%	30%
C	0%	20%	0%	40%	0%
Whiskey	0%	0%	0%	0%	40%
X-Ray	0%	0%	40%	0%	0%
Yankee	0%	20%	0%	0%	0%
Zulu	40%	0%	0%	0%	0%

Such a deviation from uniform interest can create various problems and complications. But if the parties do not directly own an interest in the license, and instead own shares in a corporation that owns the license, Party C would not be able to create a deviation from uniform ownership of interests.

Another potential advantage of using a corporate form relates to capital gains taxes. In some host countries, if an interest in a license and the operations associated with it are sold for a large gain, the possibility exists that the seller may own capital gains tax on the sale. In an effort to avoid that possibility, some parties will create a special purpose vehicle to hold the license. The special purpose vehicle might be a company organized in a tax-friendly jurisdiction. If the party decides to sell its interest, it sells its interest in the special purpose vehicle, but the special purpose vehicle continues to own an interest in the license. That way, the seller can assert that no sale has taken place in the host country even though some nations might challenge this approach and theory (including with provisions dealing with indirect transfer of interest).

2.3 Reasons Why Parties Might Choose Not to Use the Corporate Form

Although the very nature of incorporated entities provides some benefits, parties to a JOA can include provisions in their agreement that attempt, by contract, to gain some of the same benefits that can be achieved with the corporate form. For example, parties often include in their JOAs a maintenance of uniform interest provision that prohibits parties from selling portions of their interest in a manner that creates non-uniform interests.[54] This can avoid the sort of problem discussed above. Further, many JOAs contain a waiver of partition rights,[55] thereby eliminating the risk of a judicial sale of the entire license.

In addition, parties are able to use the terms of their JOAs to achieve certain other advantages that are commonly associated with the corporate form. For example, under most JOAs, the operator is given exclusive authority to conduct all operations, and the operator's conduct of operations generally is not subject to the direction or control of the non-operators.[56] This can bring about, for day-to-day operations and administration of the license, as effective a centralization of operations and administration as could be achieved by using the corporate form.

---

54 *See, e.g.*, A.A.P.L. Form 610 – Model Form Operating Agreement (2015), Art. VIII.D.

55 *See, e.g.*, A.A.P.L. Form 610 – Model Form Operating Agreement (2015), Art. VIII.E; Canadian Assoc. Petroleum Landmen (2007) Model Operating Procedures, § 25.02; AMPLA (2011) Model Form Joint Operating Agreement § 4.7.

56 *See, e.g.*, A.A.P.L. Form 610 – Model Form Operating Agreement (2015), Art. V.A (Operator will have "full control of all operations" and is "not subject to the control or direction of the Non-Operators"). In the 2012 AIPN Model Form JOA, Article provides for designation of an "Operator" and Article 4.2 provides that the Operator "shall have exclusive charge of Joint Operations, and shall conduct all Joint Operations." Section 6.1 of the AMPLA Form provides for appointment of the "Operator" and Section 7.2 provides that "the Operator is entitled to have possession and control of all Joint Venture Property and must, either itself or through such third parties as it may engage" perform various tasks, including joint operations. Section 5.1 of a standard form used on the U.K. Continental Shelf provides for designation of an "Operator" and Section 6.1 provides that "the Operator has the right and is obliged to conduct the Joint Operations by itself, its agents or its contractors." *See also* AAPL-710 (2002) § 5.1; AAPL-810 (2007) § 5.1; CAPL (2007) Model Form Operating Procedures, § 3.01.

For the non-operators, a centralization that is achieved by appointing one party to be operator comes at the cost of the operator having more control and more information regarding day-to-day operations than do the non-operators. To the extent that this is a concern, the parties can minimize this disadvantage by including in their JOAs provisions that: (1) give the non-operators a right to information and physical access to operations;[57] and (2) provide for an operating committee of all the parties that has authority to set budgets and make some other decisions regarding operational matters.[58] And in fact such provisions are common JOAs. Further, the non-operators' lack of direct control over operations under a JOA is not necessarily that different than the level of control they would have when the corporate form is used.

As for liability protection, if a party wants the liability protection that comes with the corporate form, that party can create a corporate subsidiary to own its interest in the license, and that would protect the party from any liability that exceeds its investment. Further, when parties each directly own a fractional interest in an oil and gas license, with one of the parties serving as operator, the parties may be able to structure their JOA so as to provide the non-operators with protection against direct liability to third persons for the torts committed and contracts entered by the operator. In particular, the parties seek to make sure that their relationship does not constitute a partnership or joint venture,[59]

---

57 *See, e.g.*, A.A.P.L. Form 610 – Model Form Operating Agreement (2015), Art. V.D.5; AIPN 2012 Model Form International Joint Operating Agreement, Art. 4.2.B.8.

58 AIPN 2012 Model Form International Joint Operating Agreement, Art. 6.1.D. The use of operating committees somewhat lessens the centralization of decision making, but it does so with respect to issues on which the non-operators want to retain a greater voice.

59 See, e.g., A.A.P.L. Form 610 – Model Form Operating Agreement (2015), Art. V.D.5; CAPL (2007) Model Form Operating Procedures § 1.05(A); AIPN 2012 Model Form International Joint Operating Agreement, Art. 14.1; AMPLA (2011) Model Form Joint Operating Agreement § 3.3(f).
In some jurisdictions, such as the United Kingdom, "joint venture" has no particular legal meaning or significance. But in other jurisdictions, such as most states within the United States, a "joint venture" is recognized as being a particular type of relationship that is very similar to a partnership. The primary distinction between a partnership and a joint venture "is that, while a [partnership] is ordinarily formed for the transaction of a general business of a particular kind, a joint venture is usually, but not necessarily,

and that the operator is classified as an independent contractor, rather than an agent, of the parties even though this can be challenged as well.[60]

If the parties succeed in this, the non-operators may not have any direct liability to third persons for the operator's torts and contracts. In some circumstances, this may obtain more protection to the non-operators than using a single incorporated entity that is owned by all the parties. If a single corporate form is used, the parties would not have direct liability, but each party would suffer a loss to the extent that the incorporated entity that the party owns is diminished in value because of some corporate liability. In contrast, if the parties directly own an interest and only the operator is liable to some third person, then the non-operators in some circumstances will incur neither direct liability nor a diminution in the value of their investment. Admittedly, these circumstances will be rare. In most cases, the non-operators ultimately will be responsible for liabilities arising from joint operations because, under virtually all JOAs, the non-operators agree that they generally will pay their proportionate share of such liabilities and the JOAs tend to be bound by a host granting instrument which requires joint and several liabilities of the consortium parties.[61] Thus, as between the parties, this

limited to a single transaction, although the business of conducting it to a successful termination may continue for a number of years." Daily States Publishing Co. v. Uhalt, 126 So. 228, 231 (La. 1930). See also Ben Fitzgerald Realty Co. v. Muller, 846 S.W.2d 110, 120 (Tex. App. 1993) ("The principal distinction between a joint venture and a partnership is that a joint venture is usually limited to one particular enterprise."); Texas Oil & Gas Corp. v. Hawkins Oil & Gas, Inc., 668 S.W.2d 16, 16 (Ark. 1984) ("a joint venture is 'in the nature of a partnership of a limited character'"); Boles v. Akers, 244 P. 182, 184 (Okla. 11925) ("a joint venture generally relates to a single transaction"); Bebo Const. Co. v. Mattox & O'Brien, P.C., 998 P.2d 475, 477 (Colo. App. 2000) ("A joint venture is a partnership formed for a limited purpose…."); SPW Assocs., LLP v. Anderson, 718 N.W.2d 580, 583 (N.D. 2006) ("A joint venture is generally considered akin to a partnership, although more limited in scope and duration…."); Lightsey v. Marshall, 992 P.2d 904, 909 (N.M. App. 1999) ("a joint venture 'is generally considered to be a partnership for a single transaction'"); Madrid v. Norton, 596 P.2d 1108, 1118 (Wyo. 1979) ("The principal distinction between a joint venture and a partnership is that a joint venture usually relates to a single transaction.").

60 *See, e.g.*, A.A.P.L. Form 610 – Model Form Operating Agreement (2015), Art. V.A.

61 *See, e.g.*, AIPN 2012 Model Form International Joint Operating Agreement, Arts. 3.1 and 4.6.

generally requires non-operators to pay their proportionate share of contract liabilities incurred by the operator and even pay their proportionate share of tort liabilities incurred by the operator.[62] Nevertheless, there may be some value to the non-operators in not having direct liability to third persons. More important, under most JOAs, the non-operators' promise to pay their proportionate share of liabilities is not unconditional. Under many JOAs, the operator alone must bear any liability that arises from its gross negligence or willful misconduct.[63] The vast majority of obligations that arise from joint operations do not result from the gross negligence or willful misconduct of the operator, but occasionally this limitation on the non-operators' liability will be important. In addition, some JOAs might provide even stronger protection for the Operator, providing that: (1) even if a liability arises from gross negligence or willful misconduct, the Operator still will bear only is proportionate share of such libility unless the action or inaction that constituted gross negligence or willful misconduct was committed by senior personnel; and (2) the Operator will not be liable as Operator for environmental and indirect losses as these are difficult to estimate and to bear alone such risks and costs.

For example, the explosion aboard the Deepwater Horizon and the resulting oil spill in the Gulf of Mexico in 2010 resulted in liabilities amounting to tens of billions of U.S. dollars. In that case, BP was the operator, pursuant to a JOA that required the parties to each pay their proportionate share of all liabilities arising from joint operations, unless the liability arose from the gross negligence or wilful misconduct of the operator. That exception to the non-operators' obligation, along with a plausible argument that the incident arose from gross negligence of the operator, gave the non-operators some leverage to seek a settlement in which would pay less than their proportionate share of liability, leaving

---

62 Further, under the laws of some jurisdictions, any third persons who are not paid for goods or services may be able to assert lien rights or a privilege against all owner's interest in the operation, not merely against the operator's ownership interest. *See, e.g.*, La. Rev. Stats. 9:4861 thru 9:4873

63 *See, e.g.*, A.A.P.L. Form 610 – Model Form Operating Agreement (2015), Art. V.A; CAPL (2007) Model Form Operating Procedures, § 3.04; AMPLA (2011) Model Form Joint Operating Agreement, § 6.3(c).

the operator to pay more than its proportionate share. If the parties had not directly owned their interests, and instead that had each owned shares in a corporation that owned the license, the corporation that they co-owned presumably would have borne all of the liabilities arising from the incident. Thus, at least to the extent that the corporation had assets, each of the parties indirectly would have borne its proportional share of the entire liability because of the diminished value of the corporation.

Another of the advantages often associated with the corporate form is the ease of transfer of ownership. When the corporate form is used, a shareholder or member can transfer a fractional ownership in the business enterprise without having to transfer a fractional share of each and every item of property used in the business. Instead, a shareholder or member simply transfers his shares or his membership interest.[64] But this advantage may not be very great in the case of a jointly owned license for oil and gas operations.

If an incorporated entity is used to own the license and conduct operations, the parties will have to create the entity. The formal process of incorporation typically will be simple, but the process of actually building and staffing the entity raises issues that will not exist under a JOA that governs the relationship of parties that each directly own an interest in a license. Under the typical JOA, the operator simply dedicates some of its employees to the task of operating the license. Further, the company may be able to achieve some efficiencies by using some employees who only dedicate a portion of their time to the joint operation.

If an incorporated is used, the option of using employees that dedicate just a portion of their time to the joint operation may not be readily available. Further, a new organization will have to be created from scratch. What will be the policies of this entity? How will it be staffed? Would it

[64] Sometimes the parties may place restrictions on the transfer of ownership interests. Certainly when parties each directly own interests in a license and govern their relationship with a joint operating agreement, the parties sometimes place restrictions on transfers. But these restrictions do not involve some purely practical inherent in transferring ownership in a multitude of individual things owned for purposes of the business. Rather, these restrictions are restrictions that the parties agree to impose – such as rights of first refusal (on sales of ownership interests) that run in favor of the other parties or a requirement that the other parties consent to a transfer of interests.

be staffed entirely by secondees? If so, the shareholders or members of the entity will have to agree whose employees will fill various positions. Instead of using secondees, the parties could decide that the incorporated entity will hire its own employees, but presumably the entity would be created for the sole purpose of owning and operating the one license (or perhaps a group of related licenses). The entity therefore would need to hire employees willing to join a company that operates just one license and which presumably will cease to exist once the license is no longer operated (if this entity do not have participation in other host government instruments).

Further, certain of the commercial terms by which parties typically want their relationship to be governed may be simpler to achieve with a JOA and direct ownership of a license than by use of the corporate form. An example is the choice of which operations to conduct. When parties enter JOA, they grant day-to-day control of operations to the Operator, but they might not cede to the Operator the right to decide which operations to conduct. The parties might retain the right to participate in that decision.[65] That level of control can be achieved easily enough with the corporate form by delegating such decisions to a board or committee on which all of the parties have representation. But when multiple parties directly own interests in a license, they typically enter a JOA in which they retain more individual autonomy than shareholders in a corporation generally have. As a general rule, an incorporated entity either will conduct an operation or not. Thus, in some sense, either all of the shareholder's interests participate in an operation or none do. But many JOAs contain provisions that allow each party to participate or not participate in operations.[66]

An example of a JOA form that contains such a provision is the AIPN JOA 2012 Model form (Article 7 of that form), entitled "Operations by Fewer than All Parties," authorizes and governs "Exclusive Operations." Subject to certain exceptions, the model form provides that, if a proposed

65 *See, e.g.*, AIPN 2012 Model Form International Joint Operating Agreement, Art. 5.2.

66 *See, e.g.*, AIPN 2012 Model Form International Joint Operating Agreement, Art. 7; A.A.P.L. Form 610 – Model Form Operating Agreement (2015), Art. VI.B.2.

operation has not been approved by the parties, a party that supported the proposed operation may send to the other parties a proposal for an "Exclusive Operation,"[67] sometimes called "sole risk" operations. Within a specified time after receiving such notice, each of the other parties must give notice whether they wish to participate in the proposed operation.[68] The parties that choose not to participate are deemed to have relinquished their proportional interests in the operation to the "Consenting Parties," who must collectively bear all the costs and risk of the operation.[69] If the Consenting Parties may a discovery that they decide to develop, the Non-Consenting Parties generally must be given a limited amount of time during which they may buy back into the operation, but in order to buy their way back into the operation they must pay their proportional share of costs, plus a premium.[70] The premium compensates the Consenting Parties for having borne the initial risk of the operation. A similar provision is the "non-consent" option of Article 5.13.B. The consequences will be the same as a sole risk (i.e. exclusive operation) but the only difference is that this provision protects a party who do not wish to proceed with an approved joint operation. This non-consent provision is less often used as they tend to protect smaller parties.

Like the AIPN JOA 2012 Model Form, other major JOA forms typically have provisions that allow for operations by less than all the parties.[71] Similar to Article 7 of the AIPN form, these provisions typically authorize the conduct of operations in which some parties will participate and some will not. The prevalent use of such provisions in model forms demonstrates that many parties to JOAs like this sort of clause. If parties choose to own interests in a single incorporated entity that owns an oil and gas license, it should be difficult to draft a shareholder or membership

---

67 AIPN 2012 Model International Joint Operating Agreement, Art. 7.2.A. Under the model form, it is possible that some parties will have forfeited their right to participate in such a proposed operation, and those parties will not be entitled to receive notice, but otherwise the notice must be sent to all parties.

68 *Id.* at Art. 7.2.B.

69 *Id.* at Art. 7.4.B.

70 *Id.* at Art. 7.5.

71 *See, e.g.*, A.A.P.L. Form 610 – Model Form Operating Agreement (2015), Art. VI.B.2.

agreement that provides for the possibility of operations by less than all the owners (ie without affecting all parties). But a clause that provides for some (but not all) owners bearing the costs of an operation, and for some (but not all) owners receiving the income from operations would deviate from a simple corporate model in which each share or given fraction of interest is treated the same as any other share or equivalent interest. Thus, a business model in which each party directly owns a share of the concession and the parties' relationship is governed by a JOA arguably is better suited to implementing "exclusive operations" provisions than is a model in which a single corporation owns the license and the parties own fractions of an incorporated entity.

Provisions that authorize and govern "exclusive operations" are not the only type of commercial term that may be simpler to implement when the parties directly own a license and they govern their relationship with a JOA, than when each party owns shares in a single entity that owns the license. Typically, the parties do not wish to each contribute an initial sum of cash or property sufficient to establish a juridical entity that has a sufficient stake of cash that it can function on its own, managing its own account, paying its own bills, and hopefully making a profit that it can distribute to the shareholders or partners. Instead, parties typically prefer to proceed as a group of individuals, albeit a group that has agreed to cooperate in specified ways.

One illustration of this is the fact that, under the great majority of JOAs, there is no joint account that contains a large reserve of cash. Instead, the parties operate on a pay-as-they-go basis, with each party paying its share of expenses, typically monthly. Consider, for example, AIPN JOA 2012 Model form. This is a widely-used form in international oil and gas joint operations. The model form's accounting procedure[72] provides that, each month, the Operator may submit a cash call to each of the parties for its share of the expenses that the Operator expects to

[72] There is a separate document called the "2012 AIPN Model Form International Accounting Procedure" (herein, "AIPN Accounting Procedure") that provides the accounting procedure that is designed to be used with the AIPN's 2012 Model International Joint Operating Agreement.

incur in approved operations the next Calendar Month, which the party then must promptly pay.[73] If a party's payment "exceeds its share of cash expenditures for a Calendar Month, then the next Cash Call for that Non-Operator shall be reduced by the excess."[74] Further, if the excess exceeds that party's share of the estimated expenses for the following month, that party has a right to request a refund.[75]

Other model form JOAs contain similar provisions. An Australian form requires the Operator to send authorizations for expenditure (AFE) to the parties each month, which the parties must then pay.[76] The accounting procedure for the JOA model form commonly used on the United Kingdom's continental shelf provides that the operator should bill the non-operator's each month for their respective shares of the prior month's expenditures. For onshore operations in the United States, the Model Form 610 published by the AAPL is the most commonly used form.[77] The latest version of that form, the 2015 version, gives the operator the right to bill each party for its share of the expenses estimated by the operator for the following month;[78] otherwise, the operator bills the parties each month for the expenses it incurred in conducting joint operations during the prior month. This pay-as-you-go system effectively treats the owners as separate individuals who are each participating in a common enterprise, not as persons who co-own a functioning entity.

Direct ownership of a license, with the parties' relationship governed by a JOA, is well-suited for implementing such a pay-as-you-go system. The use of a corporate form is less suited. Typically, after owners of a corporation acquire their shares, they are not obligated to answer cash calls (even though they might be required to follow an increase of capital). No doubt a shareholder or member agreement that requires the owners

---

73 AIPN Accounting Procedure §§ 1.6.1 thru 1.6.3.

74 AIPN Accounting Procedure § 1.6.5.

75 *Id.*

76 AMPLA (2011) Model Form Joint Operating Agreement, § 8.3(a).

77 Keith B. Hall, *The Operator Under Oil & Gas Joint Operating Agreements – The 3 Rs of Responsibilities, Removal, and Replacement*, Special Institute on Joint Operations and the New AAPL Form 610-2015 Model Form Operating Agreement (2016).

78 AAPL Form 610 (2015) Art. VII.C.

to answer cash calls could be drafted, but such a requirement would be unusual. Further, if the owners are effectively paying corporate obligations on a pay-as-you-go basis, such an arrangement might invite attempts by creditors of the incorporated entity to "pierce the corporate veil," thus potentially impose personal liability on the owners for the entity's debts.[79]

Finally, the corporate form may carry tax disadvantages.[80] Tax issues will vary by jurisdiction and are beyond the scope of this paper but it is worth noting in passing that in some jurisdictions use of the corporate form may result in double taxation – with a first round of taxation being imposed on the corporation's profits or simply higher taxation than on an unincorporated joint venture.[81] The incorporated entity is taxed on its profits because it is considered a person. The second round of taxation comes when each shareholder or member receives income in the form of a distribution from the incorporated entity.[82]

However, the use of a corporate form sometimes can have tax advantages in a merger and acquisition transaction. For example, if the target entity possesses relevant historical tax credits, then it could be beneficial for the new shareholder may be able to gain the benefit of such credits by merging with or acquiring the entity. If a corporate form had not been used, a person acquiring the assets used in a particular venture might be unable to acquire the advanTages of the tax credit. However, if the corporate form is used and the target entity possesses tax liabilities to be paid then those liablities will not discourage an acquisition unless

---

[79] Henn, supra n. 39 § 73 at p. 130 ("where the corporation is undercapitalized … a court might disregard the corporate entity as an insulator or nonconductor of liability") and § 146 at p. 349.

[80] See: Peter Roberts, *Joint Operating Agreements: A Practical Guide* (Globe Law Business, London 2010) 252, Scott Styles, ´Joint Operating Agreements` in John Paterson, Greg Gordon (eds), *Oil and Gas Law: Current Practice and Emerging Trends* (DUP, Dundee 2007) 273–277, Michael P. G. Taylor, Sally M. Tyne, *Taylor and Winsor on Joint Operating Agreements* (2ndedn Longman, London 1992) 27.

[81] Henn, supra n. 39§ 76 at p. 134.

[82] Henn, supra n. 39 § 17 at p. 54. In the United States, limited liability companies typically are treated as pass-through entities for purposes of federal income taxes. 26 C.F.R. § 301.7701–3(b)(1). That is, the limited liability company's profits are not taxed. Thus, there is only one round of taxation, which occurs when the limited liability company distributes profits to its members.

the tax liabilities would be absorbed by the party wishing to sell their shares in the target entity.

Anita Himebaugh describes the 'real' impact that tax applications can exercise on certain oil and gas operations in the following terms:

> In 1981 the oil and gas industry paid in excess of $ 17 billion in federal income taxes and an additional $8 billion in windfall profits taxes. Obviously any energy company's great concern is the specific tax treatment accorded its exploration and development arrangements.[83]

In short, the tax regime in a given jurisdiction can create more or less advantages to develop your upstream business through an unincorporated or incorporated joint venture. But the industry tends to favour the former option for tax and other reasons mentioned elsewhere in this paper. [84]

2.4 Unincorporated associations

When parties wish to jointly pursue a business enterprise, one option is to use an unincorporated association. There are various types of unincorporated associations that parties can use to conduct business. One of the leading types is partnership. Under one definition, "[a] partnership is an association of two or more persons to carry on as co-owners a business for profit."[85] In some jurisdictions, partnerships are considered

---

83 Anita Gefreh Himebaugh, 'An Overview of Oil and Gas Contracts in the Williston Basin' (1983) 59 North Dakota Law Review 49.

84 "The term "joint venture" is not a term of art in English or Scots 11.2 law and it can be used to refer to a specifically established limited company, a partnership or an unincorporated contractual association for a given purpose. It is the unincorporated joint venture which is used by the oil industry in the UKCS (and most commonly throughout the rest of the world). The unincorporated joint venture has been favoured by the oil industry over other possible models such as legal partnership or incorporation because of the tax advantages it provides and the lack of mutual liability which is possible under the JOA." Scott Styles, ′Joint Operating Agreements` in John Paterson, Greg Gordon (eds), *Oil and Gas Law: Current Practice and Emerging Trends* (DUP, Dundee 2007) 273–277.

85 N.Y. Partnership Law § 10.

a juridical entity, while other jurisdictions consider a partnership to be simply a relationship between the partners, rather than a juridical entity.[86] Often, civil laws systems treat partnerships as a juridical entity.[87] In contrast, the common law historically applied the "aggregate" theory to partnerships,[88] a theory which holds that a partnership is simply an aggregate of individuals, not a separate entity, because a partnership is merely a relationship between individuals. Now, however, many common law jurisdictions have enacted detailed statutory regimes to govern partnership law, so that partnership law is no largely a matter of statute, rather than common law, in those places. And many of those statutory regimes treat partnerships as entities. For example, in the United States, all 49 states other than Louisiana have adopted some version of the Uniform Partnership Act, and that Act largely treats partnerships as entities.

Whether a partnership is considered an entity or merely a relationship between the partners, certain elements or characteristics of a partnership tend to be very similar from one jurisdiction to another. One common law sources defined a partnership as: "A contract of two or more competent persons, to place their money, effects, labor and skill, or some or all of them, in lawful commerce or business, and to divide the profit and bear the loss, in certain proportions."[89] The Louisiana Civil Code, a civil law source, provides a definition that is very similar, except it includes a phrase indicating that Louisiana classifies a partnership as an entity. That definition states: "A partnership is a juridical person, distinct from its partners, created by a contract between two or more persons to combine their efforts or resources in determined proportions and to collaborate at mutual risk for their common profit or commercial benefit."[90] A previously-quoted statute that is part of a codification that has superseded the common law

---

86 Henn, supra n. 39 § 9 at pp. 50–1.

87 Henn, supra n. 39 § 9 at pp. 16–19.

88 *Id*.

89 Eastep v. Travelers Ins. Co., 235 S.W.2d 732, 734 (Tex. App. 1950) (quoting Corpus Juris Secundum and a definition attributed to Chancellor Kent).

90 La. Civ. Code art. 2801. Louisiana is largely a civil law or mixed jurisdiction, even though it is part of the United States, where the common law has predominated historically.

in one jurisdiction states that "[a] partnership is an association of two or more persons to carry on as co-owners a business for profit."[91]

If parties wish to jointly pursue oil and gas development under a particular license, there are some potential benefits associated with use of a partnership. For example, if the parties create a partnership that has employees and actually functions as an entity (whether or not the relevant jurisdiction considers partnership a separate entity), the partnership could administer and operate the license. This could allow for the centralization of administration and operation, without the need to name one of the parties as operator. Further, in some jurisdictions, such as the United States, partnerships profits generally would not be subject to double taxation in the same way that a corporate profits generally are.[92] These things are potential advantages of using a partnership, but there are also potential disadvantages to using a partnership.

First, one of the disadvantages of creating a partnership – when compared to the option of naming a party as operator – is that the parties will need to build-up the partnership. This raises issues. For example, the parties will need to determine how to staff the partnership. Will the partnership's employees be secondees who are loaned to the partnership by the partners? If so, the parties will have to determine which positions will be filled with which secondees and those secondees will have to be melded into a single organization. Or, if the partnership hires its own employees, it will have to build an organization from scratch for purposes of operating a single license. Creating a new organization is by no means an insurmountable task, but the parties can achieve centralization of administration and operations for day-to-day matters even if they do not create an entity to serve as owner and operator. As noted before, they can do so by making one party the operator. And, as also noted before, they can include provisions in a JOA to give the Non-Operators the right to information and physical access to facilities.

91 N.Y. Partnership Law § 10.

92 The partners are taxed on their share of partnership income, but the partnership itself generally is not taxed. Henn, supra n. 39 § 27 at pp. 80–1.

Further, a disadvantage of a partnership – when compared to a corporation – is that a partnership generally does not insulate the individual owners (the "partners") from liability for the partnership's obligations. In many jurisdictions, each partner potentially has liability for the entirety of the partnership's debts.[93] Whether because of these disadvantages or for other reasons, parties typically do not create a partnership that functions like an entity and which operates the oil and gas license.

It should be noted, however, that even if parties do not create a partnership that functions as an entity, and even if they do not subjectively intend to create a partnership, they may inadvertently create a partnership.[94] This can happen even if the parties each directly own their interests in the license, they name one party as operator, and they govern their relationship with a JOA. This can occur because the general rule is that, even if the parties did not consciously intend to create a partnership, a partnership is nonetheless created if the parties' relationship has the features that characterize a partnership. Parties to a JOA typically would consider such an inadvertent creation of a partnership undesirable because the existence of a partnership brings with it various legal rules that will govern the parties' relationship in a manner that the parties do not want. For example, partners generally owe fiduciary duties to each other and to the partnership,[95] and the parties to a JOA typically do not want to owe fiduciary duties to one another.[96] Instead, the parties generally would prefer that their duties to one another be more limited in scope and that those duties be defined by the JOA. For this reason,

[93] Colo. Rev. Stat. §7-60-115 (all partners jointly and severally liable for torts and breaches of trust, and jointly liable for other obligations); N.Y. Partnership Law § 26 (same); Pa. Cons. Stat. § 8327 (same); Tex. Bus. Org. Code § 152.304 (same); but see La. Civ. Code art. 2817 (the partnership is the principal obligor for partnership debts, but each partner is liable for his virile share of partnership debts).

[94] Ziegler v. Dahl, 691 N.W.2d 271, 275 (N.D. 2005); Hillme v. Chastain, 75 S.W.3d 315, 317 (Mo. App. 2002).

[95] *See, e.g.*, Colo. Rev. Stat. § 7-60-109; La. Civ. Code art. 2809; N.M. § 54-1A-301; Ohio Rev. Code § 1776.31; 54 Okla. St. § 1-301; Tex. Bus. Org. Code § 152.301; Wyo. Stat. § 17-21-301.

[96] A fiduciary duty is "[a] duty to act for someone else's benefit, while subordinating one's personal interest to that of the other person." Black's Law Dictionary 625 (6th edition 1990).

many JOA contain provisions that expressly disclaim the existence of a partnership and fiduciary duties.[97]

Closely related to the possibility that the parties will inadvertently create a partnership is the possibility, in some jurisdictions, that they will inadvertently create a "joint venture," a type of unincorporated association that is recognized in some jurisdictions.[98] A joint venture is similar to a partnership. The primary distinction between a partnership and a joint venture "is that, while a [partnership] is ordinarily formed for the transaction of a general business of a particular kind, a joint venture is usually, but not necessarily, limited to a single transaction, although the business of conducting it to a successful termination may continue for a number of years."[99] Because joint ventures are essentially partnerships for a limited purpose, joint ventures generally are governed by the same rules that govern partnerships.[100] Accordingly, parties to a

97 A.A.P.L. Form 610 – Model Form Operating Agreement (2015), Art. V.D.4; CAPL § 1.05.

98 In other jurisdictions, the term "joint venture" does not signify a type of association that has been recognized by the courts or legislation. *See note 84 above.*

99 Daily States Publishing Co. v. Uhalt, 126 So. 228, 231 (La. 1930). *See also* Ben Fitzgerald Realty Co. v. Muller, 846 S.W.2d 110, 120 (Tex. App. 1993) ("The principal distinction between a joint venture and a partnership is that a joint venture is usually limited to one particular enterprise."); Texas Oil & Gas Corp. v. Hawkins Oil & Gas, Inc., 668 S.W.2d 16, 16 (Ark. 1984) ("[A] joint venture is in the nature of a partnership of a limited character."); Boles v. Akers, 244 P. 182, 184 (Okla. 1925) ("a joint venture generally relates to a single transaction"); Bebo Const. Co. v. Mattox & O'Brien, P.C., 998 P.2d 475, 477 (Colo. App. 2000) ("A joint venture is a partnership formed for a limited purpose…."); SPW Assocs., LLP v. Anderson, 718 N.W.2d 580, 583 (N.D. 2006) ("A joint venture is generally considered akin to a partnership, although more limited in scope and duration…."); Lightsey v. Marshall, 992 P.2d 904, 909 (N.M. App. 1999) ("a joint venture 'is generally considered to be a partnership for a single transaction'"); Madrid v. Norton, 596 P.2d 1108, 1118 (Wyo. 1979) ("The principal distinction between a joint venture and a partnership is that a joint venture usually relates to a single transaction."); *see also* Henn, supra. n. 39at § 49.

100 SPW Assocs., LLP v. Anderson, 718 N.W.2d 580, 583 (N.D. 2006); Ben Fitzgerald Realty Co. v. Muller, 846 S.W.2d 110, 120 (Tex. App. 1993); Cajun Elec. Power Co-Op, Inc. v. McNamara, 452 So. 2d 212, 215 (La. App. 1984); Boles v. Akers, 244 P. 182, 184 (Okla. 1925); Madrid v. Norton, 596 P.2d 1108, 1118 (Wyo. 1979).

joint venture owe each other fiduciary duties,[101] just as partners owe each other fiduciary duties.

The mere facts that parties co-own an oil and gas lease and that they have agreed that one co-owner will operate the lease on the parties' behalf is not sufficient to create a joint venture.[102] On the other hand, the existence of a JOA will not automatically exclude the existence of a joint venture. In some such cases, courts have found that a joint venture existed.[103] In other cases, courts have determined that a joint venture did not exist.[104] The elements necessary to create a joint venture will be a question of law that depends on the jurisdiction, and whether a joint venture exists in any particular case will be an issue of fact that depends on such circumstances as the terms of the parties' agreement and perhaps on their conduct.[105] The elements necessary to form a joint venture can vary slightly from one jurisdiction to another, but in order for a joint

---

101 Texas Oil & Gas Corp. v. Hawkins Oil & Gas, Inc., 668 S.W.2d 16, 17 (Ark. 1984); Rankin v. Naftalis, 557 S.W.2d 940, 944 (Tex. 1977); Madrid v. Norton, 596 P.2d 1108, 1118 (Wyo. 1979); *see also* Henn supra n. 39 § 49 at p. 107.

102 Hamilton v. Texas Oil & Gas Corp., 648 S.W.2d 316, 320 (Tex. App. 1982) ("Joint owners of an oil and gas lease, may contract for the operation of leases by one of them and for the operator, in the event of success, to pay to the other joint owners one-half of the proceeds of the sale of and gas less the expenses of finding it, without creating a joint venture or a mining partnership.")

103 Rankin v. Naftalis, 557 S.W.2d 940, 944 (Tex. 1977) (parties were "joint venturers for the development of a particular oil and gas lease"; nevertheless, plaintiffs were denied recovery because joint venture did not extend to the property that was at issue in the litigation). As one commentator noted, "the mere existence of an agreement between an operator and non-operator is not sufficient to avoid [the existence of a fiduciary] duty." Christopher S. Kulander, *Old Faves and New Raves: How Case Law Has Affected Form Joint Operating Agreements – Problems and Solutions (Part One)*, 1 Oil and Gas, Nat. Res., and Energy J. 1, 11 (2015). Instead, courts will consider whether the terms of the agreement "create[] a partnership, joint venture, or agency relationship that may trigger a fiduciary duty." *Id.*

104 Ayco Development Corp. v. G.E.T. Service Co., 616 S.W.2d 184, 186 (Tex. 1981); Hamilton v. Texas Oil & Gas Corp., 648 S.W.2d 316, 321 (Tex. App. 1982).

105 Grand Isle Campsites, Inc. v. Cheek, 262 So. 2d 350, 357 (La. 1972); Cajun Elec. Power Co-Op, Inc. v. McNamara, 452 So. 2d 212, 216 (La. App. 1984); see also Price v. Howard, 236 P.3d 82, 91 (Okla. 2010) (existence is a question of fact); Madrid v. Norton, 596 P.2d 1108, 1118 (Wyo. 1979) (question of fact). The agreement that supports the existence of a joint venture can be either express or implied. Pillsbury Mills, Inc. v. Chehardy, 90 So. 2d 797, 801 (La. 1956).

venture to exist the putative joint venturers typically must jointly own an interest in a venture, they must have reached either an express or implied right to share in profits and losses, and they must have a mutual right of control or management of the venture. [106]

Even if the parties do not create a partnership or joint venture, it is possible, however, for the parties' relationship to be characterized in some way that triggers unwanted legal effects. This could happen, for example, if the parties are deemed to have a principal-agency relationship. Because the non-operators do not typically play an active role in conducting operations and managing the affairs of the parties, there generally is not a significant likelihood that they will be classified as agents for one another. On the other hand, the Operator conducts a wide range of activities on behalf of the parties, and someone could use this fact to argue that the operator is an agent of the non-operators. As a general rule, both the Operator and Non-Operators have an incentive to avoid the Operator being classified as an agent. The Operator has an incentive to avoid being classified as an agent because agents generally owe fiduciary duties to their principals, and the Operator would prefer the scope and extent of its duties to be governed by the terms of the JOA, rather than principal-agency law.[107] The Non-Operators have an incentive to avoid the Operator being classified as their agent because principals generally have direct liability for the torts committed[108] and contracts entered[109]

[106] Ayco Development Corp. v. G.E.T. Service Co., 616 S.W.2d 184, 186 (Tex. 1981); SPW Assocs., LLP v. Anderson, 718 N.S.2d 580, 583 (N.D. 2006); Fullerton v. Kaune, 382 P.2d 529, 532 (N.M. 1963); *see also* Henn, supra n. 39 at § 49 p.106 ("Mutual right to control" is an element).

[107] Restatement (Second) Agency § 13 ("An agent is a fiduciary with respect to matters within the scope of his agency."); Restatement (Third) Agency § 8.01 ("An agent has a fiduciary duty to act loyally for the principal's benefit in all matters connected with the agency relationship."); Johnson v. Brewer & Pritchard, P.C., 73 S.W.3d 193, 200 (Tex. 2002); Basile v. H & R Block, Inc., 761 A.2d 1115, 1120 (Pa. 2000); Burlington Northern and Santa Fe Ry. Co. v. Burlington Resources Oil & Gas Co., 590 N.W.2d 433, 437 (N.D. 1999).

[108] Restatement (Third) Agency § 7.04; Travelers Cas. & Sur. Co. v. Castegnaro, 772 A.2d 456, 460 (Pa. 2001); Marron v. Helmecke, 67 P.2d 1034, 1035 (Colo. 1937).

[109] Restatement (Third) Agency §§ 6.01 thru 6.03.

by their agents while acting within the scope of their agency, and the Non-Operators would prefer to avoid direct liability to third persons.

Often, parties to JOA attempt to avoid having the operator classified as an agent (with some exceptions such as the OGUK JOA).[110] In some JOAs, the parties do this by expressly disclaiming the existence of a principal-agency relationship.[111] In addition, some JOAs expressly declare that the Operator acts as an independent contractor.[112] The parties do this because classifying the Operator as an independent contractor is a plausible alternative to classifying the operator as an agent. Further, a person generally does not liability for the torts or contracts of his independent contractors,[113] and an independent contractor generally does not owe fiduciary duties to its employer.[114]

An alternative or additional way that many JOA attempt to make the Operator an independent contractor, rather than an agent, is by giving the operator a freedom from control and direction that is characteristic of an independent contractor, but not an agent. The major distinction between an independent contractor and an agent is that an agent is subject to the principal's direction and control, whereas an independent contractor generally is not.[115] Many JOAs give the Operator full control over day-to-day operations, and provide that the Operator is not subject to the direction and control of the non-operators with respect to the conduct of operations (though the parties, including the Non-Operators, collectively retain control over what operations are conducted). Such provisions typically are sufficient to avoid the Operator being classified as an agent for purposes of most of its conduct under JOAs.

---

110 *See, e.g.*, Oil and Gas UK (2009) JOA Model Form, Clause 6.5.8.

111 *See, e.g.*, A.A.P.L. Form 610 (2015) Model Form Operating Agreement, Art. V.A.

112 *See, e.g.*, A.A.P.L. Form 610 (2015) Model Form Operating Agreement, Art. V.A.

113 Restatement (Second) Torts §§ 409, 414; Fleck v. ANG Coal Gasification Co., 522 N.W.2d 445, 447 (N.D. 1994).

114 Horwitz v. Holabair & Root, 816 N.E.2d 272, 285–6 (Ill. 2004).

115 Enterprise Mgt. Consultants, Inc. v. State, 768 P.2d 359, 362 n.13 (Okla. 1988); Restatement (Second) Agency § 1. Of course, the person who hires an independent contractor does choose the job that will be done.

Nevertheless, even if an Operator is not classified as an agent in general, it may be classified as an agent for some limited purposes. For example, some JOAs provide that, if a party does not make arrangements to take and sell its portion of whatever hydrocarbons are produced, the Operator has the right, but not the duty, to sell the hydrocarbons on behalf of that party.[116] Some courts have held that, if the Operator does so, it acts as an agent in making the sale.[117] Further, to the extent that the Operator holds joint funds, it may be the agent of the other parties. Indeed, the AAPL Model Form 610 suggests that, to the extent that the Operator is the custodian of joint funds, it has fiduciary duties to the other parties.[118]

Assuming that the parties generally succeed in avoiding the existence of a partnership, joint venture, or principal-agency relationship, the non-operators generally will not have direct liability to third persons for the torts committed by or contracts entered by the Operator. This does not mean, however, that the Operator will have to satisfy all joint obligations on its own. JOAs uniformly provide that the Non-Operators generally must bear their proportionate share of all losses sustained and liabilities incurred in operations conducted under the agreement.[119] Such "exculpatory clauses" typically contain exceptions, but only narrow exceptions as explored elsewhere in this paper.

There are various other types of unincorporated associations that are recognized in some jurisdictions, including "limited partnerships"[120] (the type of partnership discussed earlier in this chapter is sometimes

---

[116] *See, e.g.*, A.A.P.L. Form 610 (2015) Model Form Operating Agreement, Art. VI.H.

[117] Atlantic Richfield Co. v. The Long Trusts, 860 S.W.2d 439 (Tex. App. 1993).

[118] A.A.P.L. Form 610 (2015) Model Form Joint Operating Agreement, Art. V.D.4.

[119] A.A.P.L. Form 610 (2015) Model Form Joint Operating Agreement, Art. V.A; AIPN 2012 Model Form Joint Operating Agreement, Art. 4.6; see also CAPL (2007) Model Form Operating Procedures, Arts. 4.01 and 4.02; OGUK (2011) Model Form Joint Operating Agreement, Clause 6.2.4; AMPLA (2011) Model Form Joint Operating Agreement, § 6.5.

[120] *See, e.g.*, Tex. Bus. Org. Code § 153.001; N.Y. Partnership Law §§ 90 and 121-001; Civ. Code Quebec s. 2189. Limited partnerships typically must have at least one "general partner" that is personally liable for partnership debts, but it can also have "limited partners" who do not have personal liability.

called a "general partnership" to distinguish it from the other types of associations whose name includes "partnership"[121]), "limited liability partnerships,"[122] partnerships in commendam,[123] mining partnerships, among others.[124] These and other types of unincorporated associations will not be discussed in detail here. Such organizations typically raise issues similar to those raised by corporations or partnerships, or sometimes a combination of both.

The table below summarises the key differences between an incorporated and incorporated joint venture:

[121] For example, Title 4 of the Texas Business Organization Code is entitled "Partnership." The first chapter of that Title is Chapter 151, "General Provisions." That chapter is followed by Chapter 152, entitled "General Partnerships" and Chapter 153, entitled "Limited Partnerships." Also, contrast Civil Code of Quebec Book 5, Tit. 2, Ch. X, Sections II (General Partnership) and III (Limited Partnerships).

[122] *See, e.g.*, N.Y. Partnership Law § 121-1500.

[123] *See, e.g.*, La. Civ. Code art. 2837. A partnership in commendam is similar to a limited partnership. La. Civ. Code arts. 2840, 2844.

[124] A mining partnership is a special type of partnership that has been recognized in the United States. It is governed by state law. Under Oklahoma law, there are three elements of a mining partnership: (1) a joint interest in the property; (2) an express or implied agreement to share in profits and losses; and (3) cooperation in the project. Spark Bros. Drilling Co. v. Texas Moran Exploration Co., 829 P.2d 951, 953 (Okla. 1991). Under West Virginia law, three essential elements of a mining partnership are: (1) co-ownership of lands or leases constituting a property interest; (2) joint operation thereof; and (3) sharing of profits and losses. Valentine v. Sugar Rock, Inc., 745 F.3d 729 (4th Cir. 2014); *see also* Valentine v. Sugar Rock, Inc., 766 S.E.2d 785 (W. Va. 2014).

	Use of Single Incorporated Entity to Hold License	*Each Party Directly Owns Interest in License Parties Use JOA*	*Each Party Directly Owns Interest; parties use JOA; Parties Relationship Classified as a Partnership*
Limited Liability?	Yes	No. As a general rule, the liabilities shall be proportional.	No. As a general rule, the liabilities will be joint and several.
Access to Information	Each party is owner of operator; has direct ability to seek information in theory	One party serves as operator. Other parties rely on JOA's provisions regarding the right to information	One party serves as operator. Other parties rely on JOA's provisions regarding the right to information. In addition, operator may owe fiduciary duties to other parties that may influence its obligation to provide information
Control of Operatorship	Each party is owner of operator; has direct vote, along with other parties, in actions of company	No direct control. JOA sets standards of conduct; non-operators can decide which operations to conduct; JOA may form operating committee that gives budget oversight; in specified circumstances, parties typically can remove operator	No direct control. JOA sets standards of conduct; non-operators can decide which operations to conduct; JOA may form operating committee that gives budget oversight; in specified circumstances, parties typically can remove operator

Double income tax liability?	Yes in many jurisdictions	No	No
Insulation Against Capital Gains Tax?	Potentially can obtain insulation by organizing corporation in a country that does not have capital gains tax, assuming host country does not require that corporation be organized under HC's laws	No	No
Ease of Implementing Sole Risk System	Difficult	Not difficult	Not difficult
Requirement to establish its own policies	Yes	Less likely	Less likely
Costs to create such association	Higher	Lower	Lower
Flexibility to design its own association terms and conditions	Lower as it should follow the types of forms and rights established under the applicable law for each form of incorporate entity	More flexible as it follows contract law	More flexible as it follows contract law

3 Chapter three: Alternatives to adjust a JOA model form

In order to maximize the effectiveness[125] of the joint operations, the parties determine one among them to conduct the operations on the behalf of the whole consortium.[126] In other words, the *consortium* will have one party who will act as the Operator of the consortium and the remaining will be the Non-Operators.

However, the title of the JOA implies a reasonable collaboration between all parties in the consortium not only on the consequences of the operations (i.e. costs and liabilities) but also on the preparation, decision process and execution of the operations. Under hte American JOA models, however, many decisions are left to the Operator alone, particularly decisions regarding how operations will be conducted. The Canadian mode, which similarly puts a great deal of control in the hands of the Operator, implicitly recognizes this. It is the only model from does not call itself a 'joint operating agreement,' opting instead for the title "Operating Procedures". The other models adopt a mid-approach as they provide for an Opcom. The Operator might argue that the Non-Operators can give their input via the Opcom so that everything is jointly decided. However, it is impossible to deny that the Operator will set the pace of the Opcom, as it will not only chair such body but also any subcommittee implemented, and also most of the work that will be analysed by the Opcom. As a matter of consequence, the Operator shall have far more control of the joint operations than the Non-Operators. [127]

---

125 '*In order to run the joint venture efficiently, the parties will appoint an Operator to act on their behalf.*' Sandy Shaw, ´Joint Operating Agreements` in Martyn R. David (ed), *Upstream Oil and Gas Agreements* (Sweet and Maxwell, London 1996) 16.

126 '*It would be impractical for all participants in a jointly owned contract to undertake the actual operations. Thus, the JOA provides for the designation of one of the participants as the operator who is in exclusive charge of conducting all joint operations on behalf of all participants.*' Claude Duval and others, *International Petroleum and Exploration Agreements: Legal, Economic & Policy Aspects* (2nd edn Barrows, New York 2009) 289.

127 '*Given the infrequentcy of the operating committee meetings, the standard of performance by the operator is critical.*' D. A. W. Maloney, 'Managing the Multi-Participant Joint

As previously mentioned, the Non-Operators are likely to desire greater participation in the decision-making process of the operations. On the other hand, the Operator is likely to desire more discretion so that it can determine the pace of the operations. Between and above these different positions, there is an HG who will want to maintain control over the efficiency and maximization of the production.[128]

So the main question is how to address all these different views in a balanced manner? In other words, is it possible for all these interests and views to co-exist inside the same agreement without eliminating some of them?

As we previously discussed the main issue between an Operator and Non-Operators is the tension between their roles. There are two options to solve this issue.

One option would be to use an incorporate joint venture (see chapter 2) and the entire JOA discussion and conflict of interests between an Operator and Non-Operator would not exist. The issue would be on who can staff the company and indicate positions in the management and board of the company. But most companies in the petroleum industry tend to prefer to keep the unincorporated joint venture for the reasons discussed in previous chapters.

Another option would to adjust the operatorship provision of the JOA model form to address this concern. The JOAs could offer some mechanisms to solve this operatorship tension in the following options: (i) split of operatorship, (ii) dual or co-operatorship, (iii) joint operating company, (v) third party Operator.

3.1 Split of operatorship

Companies might have different expertise and preferences from exploration to production phases. The life cycle of an upstream project and the duration of a JOA tend to be very long and it should be able to

Venture' (1988) 7(2) Australian Mining and Petroleum Law Bulletin 116.

[128] Juris Knut Kaasen, Scope of Joint Operating Agreements in Norway (Petroleum Law Seminar, St.Raphael, 2000) 19.

accommodate different Operators. A balanced provision would be the split of the operatorship.[129]

Therefore, a split of operatorship might give a fair balance of powers between the JOA parties and allow them to use their best resources and expertise to conduct the operations of the consortium throughout the life cycle of the JOA.

However, the duration of the Operatorship role might create some tension during the negotiation phase. At one hand, a Non-Operator during an exploration phase might argue that its role as an Operator is uncertain as no one knows if the project will ever reach a development and production phase. On the other hand, a Non-Operator at a development and production phases might argue that its role as an Operator in the exploration phase is likely to be much shorter than the one in the development and production phase.

In addition, some companies might not be comfortable to hand-in operations between phases or even worst some host governments might not approve such assignment. For those reasons, this option is not often used by JOA parties.

3.2 Co-Operatorship/Dual Operatorship

The Operatorship is more likely to be given to one entity at a given time. A large variety of companies and even governments might be hesitant to allow more than one party to act as Operator at the same time. It might generate more confusion and less efficiency to allow several parties to do the same role. As it is often said there is only one captain in the ship and many companies would argue that the same principle should apply to a JOA.

However, some companies and/or governments might make a distinction between a technical and administrative Operator. The technical Operator is likely to be the IOC and the administrative Operator is more likely to be the NOC. In this case, some could argue that it is not a truly

[129] Peter Roberts, *Joint Operating Agreements: A Practical Guide* (Globe Law Business, London 2010) 92–93.

dual operator but rather one company dealing with the main business of the *consortium* and another one dealing with formalities to implement the main decisions in a similar way between a captain who would make the decisions and the sergeant who would implement them.

The Greenlandic JOA provides for a fairly unique co-operative agreement which is an attachment to the main body of the JOA. [130]

This agreement is an interesting example on how NOCs without extensive expertise and knowledge could aim to become an operate in a nearby future. However, this is easier to be implemented in Greenland as Nunaoil is a NOC and this JOA is provided as an attachment of the relevant licence. Thus, any IOC interest to do business in Greenland should accept these terms and conditions and a normal Non-Operator might face more difficulties to negotiate similar terms and conditions without such statutory powers.

An easier solution would be the incorporate joint operating company as all parties would be part of the Operator as described below.

3.3 Joint Operating Company

Some parties might balance the conduction of the operations by the creation of another vehicle to operate the joint operations (i.e. incorporated operator). This option is different than the one described in chapter two of this paper as in this case the parties should first sign a JOA and then create a company to be the operator of such JOA.

Such a vehicle should be composed of all parties of the consortium (even though less than all parties could be involved inside such entity).[131]

[130] See: https://www.govmin.gl/images/stories/petroleum/udbud/udbud_2018_2018/Davis_Strait_2018/Model%20Joint%20Operating%20Agreement_App%20B_Davis%20Strait%202018.pdf. Accessed 09 November 2016.

[131] *'In exceptional instances, a separate entity may be formed to serve as operator and that entity may be staffed by the various participants.'* Claude Duval and others, *International Petroleum and Exploration Agreements: Legal, Economic & Policy Aspects* (2nd edn Barrows, New York 2009) 289.

In any case, this vehicle shall remain subject to the instructions of the relevant JOA. [132]

In simple terms, this approach would create another Opcom to perform the day to day activities of the consortium in a similar approach to many JDZs. [133]

This option to create a joint operating company is more likely to happen in a development or production phase (specially whenever a NOC is involved). But some companies might argue that this solution creates more complexities and less efficiency. There could be some overlaps and conflicts between the JOA and the shareholder agreement of the operating company.

In any case, it is relevant to stress that such solution might require more contribution from the Non-Operators and might even give more control to the Non-Operators (specially to be informed of "what is going on"). But the key issues should be determined by the decision process in the relevant committees, forums and staffing such operating company.

3.4 Third party operator

Rather than choosing one of the parties as operator or choosing an entity that is owned by one or more of the parties to serve as operator, the parties could choose a party that has no interest in the oil and gas license to serve as operator. Such an operator is sometimes called a "contract operator" or a "non-owning operator." The co-owners of a license typically do not use a contract operator.

This is reflected in the terms of the A.A.P.L. Model Forms that are commonly used in the United States. The recently-released "2015" version of the AAPL Model Form-610[134] states a general rule that the operator

132 Peter Roberts, *Joint Operating Agreements: A Practical Guide* (Globe Law Business, London 2010) 92.

133 Rajendra Ramlogan, 'State Participation in Joint Ventures: The Republic of Trinidad and Tobago Experience' (1992) 10 J. Energy & Nat. Resources L. 284.

134 The "2015" version was not released until late 2016. The first version of the AAPL Form 610 Model Form Operating Agreement was the 1956 version. Subsequent versions were

must own an interest.[135] The earlier versions of Form 610 did not expressly address whether the initial operator had to own an interest in the license, but the Forms seemed to assume that the Operator would. For example, the 1989 and 1982 Forms provide that the operator will "be deemed to have resigned" if it ceased to own an interest that is governed by the JOA,[136] and the 1977 Form states that the operator will "cease to be Operator" if it no longer owns an interest.[137] Further, the 1989, 1982, and 1977 versions of Form 610 provided that, in the event that an Operator resigned or was removed, the successor Operator would be chosen from amongst the parties that own an interest in the license.[138] Similarly, in the international context, the AIPN's JOA 2012 Model Form contains an optional provision that would allow the parties to remove the Operator if the collective participation interest (ownership fraction) that the Operator and its affiliates holds in the license falls below a specified fraction.[139]

One of the reasons that parties typically do not use a contract operator is that one or more of the parties often wishes to serve as operator. Their desire to serve as operator may come in part because, by serving as operator, a party has more influence over operations.[140]

Another reason that parties typically do not use contract operators is that they prefer to have an operator that is an owner because they believe that such an operator will have the same incentive as the other owners – an incentive to maximize profits for the owners of the license while avoiding imprudent risks. Indeed, this belief often leads parties to choose as operator the party that owns the *largest* interest.[141] In contrast to the motivations typically predominant amongst the owners of the license, the primary motivation of a contract operator will be to make a profit

the 1977, 1982, and 1989 versions. The AAPL Form 610 is the most commonly used form for onshore joint operations in the United States.

135 2015, Art. V.A.

136 1989 Form, Art. V.B.1.; 1982 Form, Art. V.B.1.

137 1977 Form, Art. V.B.1.

138 This requirement is found in Art. V.B.2 of the 1989, 1982, and 1977 Forms.

139 See optional provision Art. 4.10.C.

140 See chapter 1.

141 Ibid.

by serving as operator.[142] Such a motivation means that the operator's motives do not perfectly align with those of the owners, and such a non-alignment of interests is a concern.

Indeed, a corollary of the concern about non-alignment of interests is a commonly-held view within the industry that the operator generally should neither gain a profit nor incur a loss because of its role as operator. This view is made explicit in some international JOA forms. Article 4.2.B.5 of the AIPN JOA 2012 Model Form provides that, subject to exceptions provided in the JOA's accounting procedures or provisions for potential operator liability in the event of gross negligence or willful misconduct, the Operator should "neither gain a profit nor suffer a loss as a result of being the Operator." Article 6.3(c) of the AMPLA Form states: "It is intended that the Operator will neither gain nor, except where it has committed fraud or Wilful Misconduct, suffer a loss as a result of acting as Operator in the conduct of Joint Operations." Similarly, 6.2.2(d) of the UKCS Form states that, except in the case of willful misconduct, the Operator should "neither gain nor suffer a loss in such capacity as a result of acting as Operator in the conduct of Joint Operations."

This view also is reflected in substantive terms of JOAs – terms which have the effect of providing that the operator is not compensated for its service as operator. The operator is entitled to reimbursement of its expenses, which may include a reasonable overhead, but otherwise it works "gratuitously for the benefit of all members of the JOA."[143] Further, certain provisions in the JOA that are designed to ensure that the operator secures goods and services at a reasonable costs include extra safeguards that apply if the operator wishes to use its own materials and charge the

[142] It would be possible to base a contract operator's compensation partially on the amount of profits from operations, but it probably would be impossible to completely align the interests of the of a contract operator with the owners of a license unless the contract operator shares in both profits and losses. And if the parties provide for the contract operator to share in profits and losses they essentially have converted the contract operator into an owner. If for example, the parties agree that a contract operator would receive 1% of revenue (in addition to reimbursement of operating costs) and pay 1% of all costs, the operator effectively would be a 1% owner.

[143] Scott Styles, ´Joint Operating Agreements` in John Paterson, Greg Gordon (eds), *Oil and Gas Law: Current Practice and Emerging Trends* (DUP 2nd ed., Dundee 2007) 375.

joint account, or if it wishes to purchase services or materials from an affiliate. These measures seek to ensure that the operator does not make nor lose money based on its service as operator. This helps ensure that parties do not overpay for goods and services and that the operator does not seek to profit from its position as operator.

Nevertheless, the co-owners of a license sometimes use a contract operator. Indeed, one commentator has suggested that the practice has become more common as described below.[144] Further, the recently released 2015 version of the American Association of Professional Landmen's "A.A.P.L. Form 610 – 2015 Model Form Operating Agreement" contains provisions recognize the possibility that the parties will choose a contract operator and establish special rules that will apply if a contracts operator is used.[145] Obviously, if a company is not a co-owner of the license (or an uncompensated affiliate of an owner), then the company's only motivation to serve as operator will be to make a profit. Thus, the parties who elect to use a contract operator will have to reconcile themselves to the operator making a profit. For this reason, if the parties are using a model form that says that the operator should not make a profit, that portion of the agreement will have to be revised, or the parties will need to enter a separate agreement to govern the relationship between the operator and the non-operators. Similarly, if the parties' JOAs contains provisions that restrict the charges that an operator can charge, those provisions may need revision for use with a contract operator.

Parties who choose to use a contract operator may also find it prudent or even necessary to modify other parts of a model form (assuming they do not enter a separate agreement with the contract operator). Some of a model form's provisions relating to the operator will work fine with a contract operator, but because the forms often are written with an assumption that the operator will be an owner, some of the provisions in the model may not be appropriate for use with a contract operator.

---

[144] Scott Styles, ´Joint Operating Agreements` in John Paterson, Greg Gordon (eds), *Oil and Gas Law: Current Practice and Emerging Trends* (DUP 2nd ed., Dundee 2007) 376.

[145] A.A.P.L. Form 610 – Model Form Operating Agreement (2015), Art. V.A (2nd para.) and V.B.5.

For example, many JOAs contain broad exculpatory clauses that protect an operator from liability. One of the justifications for such clauses is that, if the operator barred from making a profit by being operator, it is reasonable for the operator to receive protection against liability. This justification does not apply when the parties use a contract operator that is allowed to make a profit from its service as operator. Thus, the parties should consider eliminating the broad exculpatory protection generally given to operators. On the other hand, the potential losses that can occur in oil and gas operations are enormous compared to the amount of profit that a company likely will be able to make by serving as contract operator. For this reason, it may be reasonable for a contract operator to demand some limitations on liability. This is reflected in some service contracts. For example, the AIPN's 2012 Model Well Services Contract contains clauses that anticipate that the well owner will indemnify the contractor against various losses relating to a loss of well control.[146] The same form anticipates that the owner also will indemnify the contractor against claims relating to damage of the subsurface, including damage to a reservoir or well,[147] and against pollution claims arising from a blowout.[148]

Parties should also consider whether they wish to make it easier to remove a contract operator than to remove an operator that is a co-owner. This is already reflected in one model form – the 2015 version of the AAPL Model Form 610. That form creates a general rule that the operator must own an interest, but the form recognizes the possibility that the parties will use a contract operator and the form establishes removal-of-operator rules that are different if the operator is a contract operator as opposed to being an owner of the oil and gas lease or leases governed by the agreement.

One of the 2015 Form's special rules is that a contract operator may be removed by a majority (in interest) of the owners, with or without good cause.[149] In contrast, an operator that is an owner may only be removed

146 See Article 13.2.5.

147 AIPN 2012 Model Well Services Contract, Art. 13.2.6.

148 AIPN 2012 Model Wells Services Contract, Art. 12.2.10.5.

149 A.A.P.L. Form 610 (2015) Model Form Operating Agreement, Art. V.B.5.

for good cause.[150] Further, the AAPL Model Forms provide that the parties generally cannot remove an operator that is an owner unless the operator does not correct a "default" that constitutes good cause for removal within a specified time after being given written notice of the default.[151] Under the 2015 AAPL Model Form, however, a contract operator is not entitled to such notice and an opportunity to cure before being removed.

Consequently, it is possible to say that the JOA parties would avoid most of their conflicts as a neutral third party would perform the work as per decision of their Opcom. Sandy Shaw describes the importance of such alternative to minimise concerns about overheads as follows:

> *There is a growing trend in delegating in delegating major operating functions to contractors in an effort to reduce operating costs and overheads. At present, JOAs do not tend to deal in any detail with contractor-operator situations. In cases where contractors' services are used for day to day operations, the parties will expect to be fully consulted and consent to such arrangements and any JOA amendments that may be required.* [152]

In other words, the delegation of a third-party operator would avoid most of the conflicts between the JOA parties and none of the JOA parties would have any difficulty in requesting higher levels of control and performance on such a service agreement. However, none of the JOAs standard forms available in the industry offer this type of arrangement as the two basic principles of most JOAs are not fulfil: (i) the Operator is a consortium member, (ii) the "Non Gain No Loss" principle as this third party would be paid to take this role.

---

150 A.A.P.L. Form 610 (2015) Model Form Operating Agreement, Art. V.B.4.

151 A.A.P.L. Form 610 (2015) Model Form Operating Agreement, Art. V.B.4. The time that the operator has to cure the default generally is 30 days, but the time is limited to 48 hours "if the default concerns an operation then being conducted." *Id.*

152 Sandy Shaw, ´Joint Operating Agreements` in Martyn R. David (ed), *Upstream Oil and Gas Agreements* (Sweet and Maxwell, London 1996) 14.

3.5 Other practical examples

An interesting analogy occurs with the development of areas closer to the boundaries of different countries. As sovereign countries each one would prefer to maintain strong control over its resources and operations; [153] however, this might not be in the best interest of both countries, as an efficient exploration of such zone would require cooperation between them. In this sense, these countries might sign an agreement (Joint Development Zone – JDZ) or cross border unitisations to secure the maximisation of the recovery of the natural resources.[154]

It is important to note the fact that the JDZ and cross border unitisations are commonly controlled by both countries; otherwise they would not accept the partial abdication of their sovereignty..[155]

The same principle shall be applicable for the JOA as the situation is fairly the same (i.e. sharing risks and resources) but applicable to a relationship between private parties rather than governmental authorities. As a matter of fact, the similarity is greater with regard to the sharing of costs.[156] As a matter of fact, all JOA parties and the HG are keen to maximise the production of hydrocarbons in the most efficient way, so the final goal is the same for everyone. Consequently, it is possible to suggest that a higher degree of efficiency could only be implemented if a balanced agreement is establish between the parties so that everyone

---

153 Chidinma Bernadine states that *'The parties wanted a strong powerful JC. In view of this, they needed a kind of check on those powers.'* Chidinma Bernadine Okafor, 'Model Agreements for Joint Development, a Case Study' (2007) 25 J. Energy Nat. Resources L. 98.

154 Peter C. Reid, 'Joint Development Zones Between Countries (1987) 6(1) AMPLA Bulletin 4,13.

155 Peter C. Reid, 'Joint Development Zones Between Countries' (1987) 6(1) AMPLA Bulletin 4,13.

156 Chidinma Bernadine states that *'Another interesting feature of the JA is the arrangement for its funding. Both states are to initially support the Authority but in the long term, it is to be funded by the oil revenue generated in area A. Nevertheless, the two states stand surety, in equal shares, for any shortfalls of the JA arising from its inability to pay, wholly or in part, an arbitral award against it under a production sharing contract.'* Chidinma Bernadine Okafor, 'Model Agreements for Joint Development, a Case Study' (2007) 25 J. Energy Nat. Resources L. 73.

has equal participation in the conduction and performance of the joint operations, i.e. a real and effective combination of joint efforts.[157]

However, it is important to note that the context between the parties in JOA to a JDZ is substantially different. The former is based on a context where one party has a dominant position in the agreement. The latter is based on a context where the parties are in an equitable relationship as each country has its own sovereignty. In this sense, the JDZ is a good example of the result of a balanced agreement to jointly explore and exploit hydrocarbons and to understand how they define the conduct of the relevant operations.[158]

It is important to note that several countries have adopted a JDZ or a cross border arrangement such as Iceland/Norway, France/Spain, Jamaica/Colombia, UK/Norway, Senegal/Guinea Bissau, Nigeria/ Sao Tome, Czechoslovakia/Austria, Sudan/Saudi Arabia, Qatar/Abu Dhabi, Saudi Arabia/ Bahrain, Australia/Indonesia, Japan/Korea, Malaysia/ Thailand, Malaysia/Vietnam, Australia/East Timor, Netherlands/ Germany, Argentina/UKF.[159] Although several countries had signed a JDZ or cross border unitisation their total number is far smaller in comparison with JOAs. Firstly, the number of private players is far greater than public players. Secondly, the licensed area is far smaller than the one involved in a JDZ or cross border unitisation which allows more deals.[160] Consequently, it is possible to argue that the experience acquired from JDZs or cross border unitisation is not as well developed as JOAs. Nevertheless, it is not possible to deny the existence of such

157 Peter C. Reid, 'Joint Development Zones Between Countries' (1987) 6(1) AMPLA Bulletin 4,13.

158 Ibid 72–73.

159 Ibid 58.

160 David Ong, 'The 1979 and 1990 Malaysia-Thailand Joint Development Agreements: A Model for International Legal Co-operation in Common Offshore Petroleum Deposits?' (1999) 14(2) *International Journal of Marine and CoastalLaw207* at 245, M. Miyoshi, 'The Joint Development of Offshore Oil and Gas in Relation to Maritime Boundary Delimitation' (1999) 2(5) International Boundary Research Unit Maritime Briefing 41, M. Miyoshi, 'Some Comments on Legal Aspects of Precedents for Joint Development' (1981) 6(11) *Energy* 1359, Chidinma Bernadine Okafor, 'Model Agreements for Joint Development, a Case Study' (2007) 25 J. Energy Nat. Resources L. 58.

practical mechanism which provides balanced terms to conduct the joint operations.

Therefore, the JDZs and cross border unitisations are a good example on how to balance different interest in a positive manner towards the mutual benefit of the parties as they need to find a solution and agreement on who is going to conduct the operations of such unitised area.

4 Conclusion

In conclusion, the reality in the upstream sector is that oil and gas companies tend to prefer to adopt unincorporated joint ventures rather than incorporated joint ventures. Usually they prefer unincorporated forms because when they use such forms they have more discretion and flexibility to design their relationship, and because they might be able to utilize better tax schemes through this option. But the incorporate joint venture could also secure some positive solutions to control the operations, operate the assets and to reduce certain liabilities.

But we also explored options to adjust the existing JOA model forms to provide more control for the parties on how to conduct the operations of the consortium.

The third party Operator is an interesting alternative to balance the position between the JOA parties, as a neutral party will perform the operations generally decided by them. However, it will change the format of the JOA. Firstly, the third party is less likely to become a member of the JOA and so the JOA will have to adjust accordingly. In this semse, the JOA parties should sign a separate contract with the third party. Secondly, the third-party Operator is likely to require government approval. Consequently, this third-party Operator might be an interesting solution to balance the position of the JOA parties, but the practicability of such an alternative is highly complex. However, the major obstacle for such an alternative is the complexity involved in the implementation of two agreements simultaneously and the transfer of the Operator 'powers' to a third party. For these reasons, such alternative is not well accepted in the industry for E&P activities but it is more commonly accepted for Lifting Agreements ('LA').

However, the split of operatorship or a special vehicle operator is far more common in the E&P industry. The practicability of these alternatives is found not only on agreements between countries (i.e. JDZ), but also

between private parties such as the Unit Operating Agreement ('UOA')[161] which establishes the same concept of the JDZ inside the same jurisdiction (i.e. Unitisation).[162] If the JDZ, UOA and LA address and deal with the same situation, or a situation that is fairly similar to a JOA,[163] then why is it not possible to provide these alternatives for a JOA? Some practical examples from the JDZ have shown whether they might work or not, but it remains a valid alternative to balance the desires of two parties with different views and wishes. Consequently, the most reasonable answer is that these alternatives require far more complex structures of operation management than a single party-operator. However, their major obstacle is the reduction of authority currently provided to the Operator.

---

161 Kenneth Barnhill explains the similarity between a JOA and a UOA as follows: *"Joint operations" is the term generally used to refer to the procedure whereby co-owners of mineral properties agree upon the development and operations of such properties by one or more of the co-owners for the benefit of the other co-owners. "Unitized operations" denote a similar arrangement, but generally on a larger scale, such as for the exploration, development, and operation of an entire pool, structure or field, or a substantial portion thereof.'* Kenneth E. Barnhill Jr., 'Taxation of Oil and Gas Operating Agreements, The Scope and Application of I. T. 3930' (1953–1954) 26 Rocky Mountain Law Review 133.

162 See: Richard R. Paradise, 'Unit Operation, The Rights, Duties and Remedies of the Working Interest Owners' (1959–1960) 32 Rocky Mountain Law Review 128, Kristen Grover, 'A Conceptual Comparison Between Unitisation Under Australian Petroleum Legislation and Coordination Under the Petroleum and GAS (Production and Safety) Act 2004 (QLD)' (2005) 24 ARELJ 331.

163 For further information see: David Edward Pierce, 'Coordinated Reservoir Development, An Alternative to the Rule of Capture for the Ownership and Development of Oil and Gas' (1983) 4 J. Energy Law & Policy 129, Francis N. Botchway, 'The Context of Trans-Boundary Energy Resource Exploitation, The Environment, the State and the Methods' (2003) 14 Colo. J. International Environmental Law & Policy 191, David M. Ong, 'The 1979 and 1990 Malaysia-Thailand Joint Development Agreements: A Model for International Legal Co-operations in Common Offshore Petroleum Deposits?' (1999) 14 International J. Marine & Coastal L. 207, Chidinma Bernadine Okafor, 'Model Agreements for Joint Development, a Case Study' (2007) 25 J. Energy Nat. Resources L. 58, Michael Dulaney, Robert Merrick, 'Legal Issues in Cross-Border Oil and Gas Pipelines' (2005) 23 J. Energy & Nat. Resources L. 247, David M. Ong, 'Joint Development of Common Offshore Oil and Gas Deposits, "Mere" State Practice or Customary International Law?' (1999) 93 Am. J. Int'l L. 771, John Holmes, 'End the Moratorium, The Timor Gap Treaty as a Model for the Complete Resolution of a Western Gap in the Gulf of Mexico' (2002) 35 Vanderbilt J. Transnational L. 926, Peter C. Reid, 'Joint Development Zones Between Countries' (1987) Vol. 6(1) AMPLA Bulletin 4, Pat Brazil, 'Comments, Historic Timor Gap Agreement Reached – Framework and Implications' (2001) 20 AMPLJ 133.

The dual or co-operator are less common practices in the industry as they could create more complexities rather than solutions. Usually the industry and even governments might prefer to deal with only one person rather than multiple entities as an operator.

In other words, these alternatives exist and might provide a reasonable balance between the parties even though it will require more complex arrangements and cooperation. However, the most interesting fact is that almost most of the standard forms of the JOA do not provide for any such alternatives to balance the position between the Operator and Non-Operator. This is probably the most blatant display of evidence to show the dominance exercised by the Operator and the lowered expectations with regard to the Non-Operator as a party, as well (and perhaps more importantly) as an investor.

The final question is this: Are the Non-Operators willing to accept such imbalance imposed by the Operator while continuing to proportionally share all the risks and costs involved at the same time? The Deepwater Horizon accident and the conflict between the JOA parties (i.e. BP, Anadarko and Mitsui) have shown the likelihood that the Non-Operators will challenge their agreements with regard to any possible right they might find under the applicable law to avoid the draconian consequences of any failure of performance.[164]

As a matter of fact, the Operator should be more interested in obtaining the Non-Operators' participation as it might avoid eventual uncertainties about possible court relief against the Operator, based on lack of input or even acknowledgment from Non-Operators over the conduction of such operations.

[164] According to the daily finance *'As the liabilities associated with Deepwater Horizon mount, Anadarko and BP will surely square off in court to determine whether or not Anadarko has to kick in 25%. Anadarko will litigate how culpable BP was for the spill, an effort that directly aligns its interest with the plaintiffs' in all the other pending litigation. Indeed, BP is currently considering initiating that war.'* For further information see: < http://www.dailyfinance.com/2010/06/21/bp-oil-spill-update-anadarko-turns-on-bp-is-20-billion-enough> [Accessed on 04 November 2016].

In conclusion, all JOAs should provide balanced and equitable provisions in order to minimise uncertainty[165] and to maximise efficiency.[166] The essence of such balance was described by D. Maloney as follows:

> Given the likelihood that the members of a multi-participant joint venture will have disparate financial resources, joint venture agreements ordinarily include provisions which are designed to ensure that:
>
> a) the weaker participants are not forced out of a joint venture by reason of being unable to 'keep up' with the rate of expenditure of the stronger participants; and
>
> *(b) exploration, appraisal and development progress at a reasonable rate, rather than that at which the Weaker participant's financial resources permit.*[167]

In addition, for mature operations where the parties are likely to be in equitable[168] positions, most of the current JOAs will provide adequate terms so that such agreements lose their functionality.[169] In other words, if most standard forms provide favorable terms for the Operator party, then the Non-Operators are unlikely to accept such model forms under a scenario of similar financial and technical capabilities. Consequently,

---

165 *'In most alliance agreements there will inevitably be some issues that are left open, but this is the nature of the agreement.'* James Lacey, 'Partnering and Alliancing, Back to the Future?' (2007) 26 ARELJ 82.

166 Thomas C. Marvin, 'Above the Law? Dealing with the abuse of Joint Operating Agreements under the Newspaper Preservation Act' (1995–1996) 42 Wayne L. Rev. 1719, Michael Moy, 'Beware! The Unfair Contracts Jurisdiction' (2005) 24 ARELJ 227, John Tarrant, 'Agreements to Co-Operate at Common Law' (2006) 25 ARELJ 281, James D. Dinnage, 'Joint Activities Among Gas Producers, the Competition Man Cometh' (1998) 16 J. Energy & Nat. Resources L. 249.

167 D. A. W. Maloney, 'Managing the Multi-Participant Joint Venture' (1988) 7(2) Australian Mining and Petroleum Law Bulletin 118.

168 Rachel A. Hird, 'Thomas W Walde and Fair and Equitable Treatment' (2009) 27 J. Energy & Nat. Resources L. 377, Roscoe L. Barrow, 'The Fairness Doctrine: A Double Standard For Electronic and Print Media' (1974–1975) 26 Hastings L.J. 659, Dominic E. Markwordt, 'More Folly than Fairness, The Fairness Doctrine, The First Amendment, and the Internet Age' (2009–2010) 22 Regent U. L. Rev. 405 2009–2010.

169 See: John R. Meyer, William B. Tye, 'Toward Achieving Workable Competition in Industries Undergoing a Transition to Deregulation, A Contractual Equilibrium Approach' (1988) 5 Yale J. on Reg. 273.

they will propose new terms for their contractual arrangements rather than adopting the model forms available.

Finally, for current and most of all future operations, it will be necessary to find balanced and equitable terms to conduct and execute the joint operations (specially in mature areas). Nevertheless, it is important to note that balanced terms and adequate participation of all parties will demand a higher degree of collaboration between the JOA parties in order to implement an effective and efficient instrument. The current imbalanced JOAs seek to avoid this by creating an 'unilateral mechanism' to perform the joint operations.[170] However, under a balanced scenario between the JOA parties (i.e. financial, technical, personnel capabilities) the management of the joint operations is likely to be as challenging as the current imbalanced scenario. [171]

[170] D. Maloney describes this situation in the following terms *'Multi-participant joint ventures are difficult and expensive to manage. At technical committee meetings, the number of geologists, geophysicists and engineers present makes it difficult to reach consensus on technical strategies. The same is true of operating committee meetings, at which the programs and budgets to give effect to the technical committee's recommendations must be considered and adopted. As the number of participants increase, so do the costs of duplication of reports, maps, minutes and general communications. Field inspections become expensive and difficult to manage. Joint venture managers become pre-occupied with co-venturer's queries and suggestions, rather than with the implementation of approved programs.'* D. A. W. Maloney, 'Managing the Multi-Participant Joint Venture' (1988) 7(2) Australian Mining and Petroleum Law Bulletin 115.

[171] *'Managing a multi-participant joint venture is a difficult task. The task is made easier if the co-venturers selected have similar financial capacity, corporate objectives and exploration strategies. In the troubled times ahead, the importance of selecting compatible co-venturers will be amplified.'* D. A. W. Maloney, 'Managing the Multi-Participant Joint Venture' (1988) 7(2) Australian Mining and Petroleum Law Bulletin 125.

Joint Operating Agreements:

Understanding different interests and concerns in the wake of *Reeder v. Wood County Energy*

Christopher Mathews[1] and
Eduardo G. Pereira[2]

1 PhD candidate at Reykjavík University and a licensed attorney in the United States. He holds an MSc degree in sustainable energy science from Reykjavík University and a JD in law from Georgetown University Law Center (Washington DC). He can be reached at christopher15@ru.is.

2 Professor of energy law at the Externado University of Colombia and a research fellow at the Scandinavian Institute for Maritime Law – University of Oslo (Norway)

Contents

I. INTRODUCTION 73

II. THE VALUE OF JOINT VENTURES 74

III. THE JOINT OPERATING AGREEMENT (JOA): FOUNDATION OF JOINT VENTURES 76

- a. The Operator 77
- b. The Participants 78
- c. Third parties 78

IV. THE OPERATOR'S OBLIGATIONS AND LIABILITIES TO THE PARTICIPANTS 79

V. THE REEDER DECISION: TEXAS FURTHER NARROWS OPERATOR LIABILITY 84

- a. Background 84
- b. Trial proceedings 86
- c. The intermediate appeal 86
- d. Appeal to the Texas Supreme Court 88
- e. Analysis 90

VI. ACTION POST-REEDER 92

VII. CONCLUSION 96

I. Introduction

When the Texas Supreme Court handed down its decision in *Reeder v. Wood County Energy,*[3] a landmark decision narrowing the scope of operator liability under a widely-used model joint operating agreement, the immediate result was consternation and confusion. Indeed, some commentators, noting the expansive protection for operators in the wake of the decision, even questioned whether joint operating agreements still made sense for the other, non-operator parties.[4] This paper discusses the value of joint ventures; the joint operating agreement that serves as the foundational document for such ventures; the allocation of duties and liabilities between the parties to a joint operating agreement; and the underlying facts, procedural history, and outcome of the *Reeder* case and its implications going forward.

3 *Reeder v. Wood County Energy et al.*, 395 S.W.3d 789 (Tex. 2012).

4 *See e.g.,* MP Averill and CW Sartain, 'Operators Liable Only for Gross Negligence or Willful Misconduct' (Energy and the Law, 2012) <http://www.energyandthelaw.com/files/2012/09/Reeder-v.-Wood-County-Energy-LLC-et-al1.pdf>, accessed 19 April 2016.

II. The value of joint ventures

Exploration for and development of oil and gas resources typically is a capital intensive enterprise involving complex, specialized, and expensive equipment that must be used by skilled and experienced workers.[5] The work is often conducted in places fraught with danger: in hostile deserts and deep, unforgiving seas, for example, or areas lacking substantial infrastructure or rife with political conflict.[6] The enterprise itself involves extraction of resources usually from miles beneath the earth. In short, it is a challenging business characterized by high upfront costs and substantial risk.

This risk can be managed through the use of joint venture arrangements in which many parties pool their resources to achieve a common benefit – the development of (and profit from) a lucrative resource – while undertaking only what each deem to be a manageable and acceptable level of risk.[7] Because the parties are able to join together to contribute their financial resources, management experience and technical expertise, they each can afford to participate in more projects. This increases the breadth of their exposure to potential loss, but at the same time reduces the depth of their exposure in any one venture. Like an investor purchasing a diversified portfolio of stocks, joint venturers can participate in many projects while limiting their risk of a catastrophic single failure. This lets them increase or decrease their activity as their own situations warrant, and benefits the industry by allowing more projects access to a

---

5 Nkaepe Etteh, 'Joint operating agreements: which issues are likely to be the most sensitive to the parties and how can a good contract design limit the damage from such disputes?' (Centre for Energy, Petroleum and Mineral Law and Policy, 2010) <http://www.dundee.ac.uk/cepmlp/gateway/index.php?news=31272>, accessed 10 April 2016.

6 Eduardo G. Pereira, *Encyclopaedia of Oil and Gas Law,* vol. 1 (Globe Law and Business, 2014) 103–104.

7 Kosia Kasibayo, 'Fiduciary relationship between an operator and non-operators under a JOA: do the fiduciary duties get extinguished upon control of the operator by the non-operators?' (Centre for Energy, Petroleum and Mineral Law and Policy, 2013) <http://www.dundee.ac.uk/cepmlp/gateway/index.php?news=32786>, accessed 10 April 2016.

greater number of participants and the capabilities they each can bring to bear. Perhaps most important, the fact that there are more players in the industry means there are more places for projects to turn for funding and for other resources, in turn increasing the stability and likelihood of success for each project.

III. The joint operating agreement (JOA): foundation of joint ventures

Joint ventures are typically organized according by a contract called a joint operating agreement (JOA). "Persons wishing or being obliged by regulation to undertake petroleum operations on a joint basis will have to negotiate and enter into an agreement with each other which sets out the rules and procedures governing their co-operation … referred to as a joint operating agreement."[8] A JOA "is a contract between two or more parties creating a contractual framework for a [joint venture] between them," under which they will conduct operations.[9] Sometimes called the joint venture's "constitution,"[10] the JOA defines and divides obligations and rights among the parties to the venture. Because oil and gas ventures are typically complex arrangements involving multiple parties and activities spanning months or often years, JOAs must be broad and flexible enough to cover the potentially-differing views and interests of all the Parties, and also to respond to changes in those interests over time.[11] In terms of importance, an oil and gas JOA is second only to the host government agreement granting access to the resource itself.[12]

Although all ventures are in some senses unique, there are common issues that arise and must be dealt with in each. These include, *inter alia,* who has the right to day-to-day decision-making, who may commit the venture to what sorts of obligations and what authorization (if any) is required to do so, passmarks, procedures for cash calls and other payments, defaults, exclusive operations and dispute resolution.[13] Rather than

8 Bernard Taverne, *An introduction to the regulation of the petroleum industry: Law, Contracts and Conventions* (Graham & Trotman, London 1994) 133.

9 Etteh (n. 5).

10 PA Bukari, 'Joint Operating Agreements: how can the most sensitive issues that arise between parties be addressed?' (Centre for Energy, Petroleum and Mineral Law and Policy, 2013) <http://www.dundee.ac.uk/cepmlp /gateway/index.php?news=32758>, accessed 10 April 2016.

11 Etteh (n. 5).

12 Kasibayo (n. 7).

13 For a non-exhaustive list of topics typically covered by JOAs, see Pereira (n. 6) 106–120.

pay lawyers to draft a new agreement from scratch for each venture – a process which would likely entail increased cost, delay, and possibility of an impasse that might halt the venture in its infancy – joint venturers typically rely on "form" or "model" agreements that cover most common issues. The form agreements can then be used "as-is" or modified as the parties see fit.[14]

The parties to the JOA fall roughly into two categories: the Operator and the non-operator Participants. These are described in more detail below.

a. The Operator

The Operator of a JOA is the person or entity who conducts the day-to-day operations of the entire venture on behalf of the parties who bear the costs and/or share in the benefits of the venture. These parties and their share of the venture's risks and rewards are commonly called "participating interests." The Operator usually holds a participating interest; often, the holder of the largest interest will insist on serving in this role.[15]

Because the Operator carries such a large share of responsibility for success or failure of the joint venture, it is essential that the person or entity selected for the role have sufficient resources and technical expertise to run it. The selection of an Operator may be hotly contested and may be of special interest to related parties, such as the national oil company. Where more than one venturer wants to exercise control or oversight over the joint venture, the participating interests may create a special-purpose entity with multiple owners to serve as the Operator. In the alternative, the participating interests may hire a third party to take this role.[16]

---

14 ibid.

15 Patrick Murphy, 'Joint Operating Agreements: Should Elements of the AIPN Model Form International Operating Agreement Influence a New AAPL Joint Operating Agreement?' (Association of International Petroleum Negotiators, 2012) < https://www.aipn.org/StudentComp.aspx>, accessed 12 April 2016.

16 MK Kanervisto and EG Pereira, 'National Oil Companies Operating in Upstream Petroleum Projects and Participating in Joint Operating Agreements' (OGEL, 2013).

b. The Participants

The holders of participating interests who do not act as Operator are the non-operator participants, more commonly referred to simply as Participants. A participating interest generally includes the right to beneficial ownership as a tenant in common of a percentage share of the property, which includes the right to receive and dispose of its percentage share of the petroleum produced under the JOA, as well as the obligation to contribute its percentage share of joint expenses; and a percentage share of all other rights and obligations accruing under the Agreement. Depending on how the JOA is structured, representatives of the non-operator Participants may sit on a Joint Operating Committee (if they have such a mechanism in the JOA) with oversight rights as to certain activities by the Operator.[17]

c. Third parties

Although the parties to a JOA are generally only the joint venturers themselves, there are many other parties with direct or indirect relationship with the JOA. These include, *inter alia,* anyone doing business with the venture, or whose interests might otherwise be affected by determining who has the right to enter into contracts for the materials or work needed by the venture, or who might seek to purchase or market the oil or gas produced by it, or a local community. Other third parties such as contractors, unions, and materialmen need to know the scope of authority of the Operator. Insurers need to know the nature and the scope of liability they are underwriting for the venture, its Operator, and the Participants: for example, what claims can be filed and what defenses asserted, when and by whom. These third parties, however, are outside the scope of this paper.

17

IV. The Operator's obligations and liabilities to the Participants

As previously mentioned, the Operator of a JOA is the person or entity who conducts the day-to-day operations of the entire venture on behalf of the parties who bear the costs and/or share in the benefits of the venture. But what is the liability between the Operator and the non-operator Participants? What kind of losses will be shared by all parties? Should the Operator be exclusively liable under certain types of activities or performance? To answer any question related to the liability of the Operator one must first understand the key points on how the obligations of the JOA parties are commonly established.

First, any JOA should be directly related to the host government instrument which gave rise to the joint venture consortium.[18] This instrument is likely to impose several and joint liabilities for all parties to the JOA.[19] Host governments generally are keen to protect their interests so they can pursue some, any, or all of the JOA parties to enforce the obligations in the host government contract.

Second, the JOA will usually seek to depart from this strict joint and several liability,[20] allocating liability proportionally according to each venturer's participating interest in the JOA.[21]

---

18 Bernard Taverne clearly explains this requirement: "*Before being able to undertake any joint petroleum operations the co-operating parties are required to be in possession of a licence or a contract of work. Such licence or contract may be held by the parties jointly in undivided interest, each party possessing a proportional interest in the licence or contract, or by a legal entity which the co-operating parties may have established for this purpose. (…) The parties must make provisions for the joint company to apply for and acquire the required licence or contract.*" (Bernard Taverne, *An introduction to the regulation of the petroleum industry: Law, Contracts and Conventions* (Graham & Trotman, London 1994) 133.

19 Peter Roberts, *Joint Operating Agreements: A Practical Guide* (Globe Law Business, London 2010) 47.

20 ibid.

21 See: Chris Wilkinson, *Joint Ventures & Shareholder´s Agreements* (3rd ed. Bloomsbury Professional, West Sussex 2009) 3–5 and Gerard M. D. Bean, *Fiduciary relationships,*

Third, JOAs generally operate under a philosophy of "no gain, no loss."[22] The Operator ordinarily will not profit from serving in that role, nor bear any incremental risk from doing so. Instead, the Operator bears liability only to the extent of its own participating interest for any action or omission from the conduct of the joint operations. This principle is usually embodied in the JOA in a so-called "exculpatory clause" which provides that simple mistakes and negligence on the part of the Operator impose no special liability; they are instead accepted by the JOA parties as part of the ordinary risks of the venture, with each party bearing their proportional share of any cost stemming from the error.[23]

Fourth, the parties provide reciprocal indemnities to strengthen the effect of the exculpatory clause.[24] In this sense, the principle of no loss is clearly shown. As Peter Roberts notes,

> *To reinforce this protection of the operator, the parties (including the party which is appointed as the operator, in its capacity as a party) will also undertake to indemnify the operator (in the proportion of*

fiduciary duties and joint ventures: the joint operating agreement (University of Cambridge, Cambridge 1992) 19.

22 *See* Sandy Shaw, "Joint Operating Agreements" in Martyn R. David (ed.), *Upstream Oil and Gas Agreements* (Sweet and Maxwell, London 1996) 16, Chris Thorpe, *Fundamentals of Upstream Petroleum Agreements* (CP Thorpe, UK 2008) 126, Hugh Dundas, "Joint Operating Agreements: An Introduction" (1994 Summer Programme: UK Oil and Gas Law, CPMLP 09/09, 1994) 12.

23 Peter Roberts describes this issue as follows: *"To this end, the JOA typically provides (in what is sometimes called an 'exculpatory clause') that the operator will not be responsible for any loss or liability suffered by a party (or by a third party and claimed against the operator or any of the parties) and which results from the operator having exercised (or having failed to exercise) the obligations which it has under the JOA."* Peter Roberts, *Joint Operating Agreements: A Practical Guide* (Globe Law Business, London 2010) 155.

24 For further information about indemnities see: Greg Gordon, ´Risk Allocation` in Greg Gordon, John Paterson (eds), *Oil and Gas Law: Current Practice and Emerging Trends* (DUP, Dundee 2007) 335–382, Ernest E. Smith et al., *International Petroleum Transactions* (3rd edn RMMLF, Westminster 2010) 546–579, D. O. Sabey et al., 'Indemnity and Insurance Clauses in Joint Venture, Farmout and Joint Operating Agreements' (1970) 8 Alberta Law Review 210, J. W. Carter, 'Contractual Indemnities, Are They Worth Having?' (2009) 28 ARELJ 169, Peter Holden, 'Commentary on Contractual Indemnities in the Context of Resources Joint Venture Agreements' (2009) 28 ARELJ 176 and Peter Holden, 'Contractual Indemnities in the Context of Resources Joint Venture Agreements, Some further Thoughts' (2010) 29 ARELJ 171.

> *their respective [participating interests]) for any such loss or liability for which the operator might otherwise be responsible. Through this combination of disclaimed responsibility and indemnity coverage, the operator is effectively insulated from liability.*[25]

It is important to note, however, that any indemnity provided in the JOA must be "clear and unequivocal" and/or "conspicuous." Courts may not enforce indemnity provisions that do not meet these requirements.[26]

Fifth, there are some exceptions to the exculpatory clause as the Operator is not given a "free pass". The exculpatory clause generally defines the level of the performance required of the Operator, and provides that the Operator must act diligently, prudently and in accordance with applicable laws, regulations and best oil and gas practice.[27] Scott Styles describes this situation as he states that:

> The nature of the duty is usually specified in the JOA as that of "a reasonable and prudent Operator" or as the duty to perform the role of operator in "a proper and workmanlike manner" in accordance with "good and prudent oil and gas field practice". The exact nature of what counts as good and prudent oil field practice will depend upon the circumstances and will also change as technology changes. [28]

25 Peter Roberts, *Joint Operating Agreements: A Practical Guide* (Globe Law Business, London 2010) 156.

26 Ernest E. Smith et al., *International Petroleum Transactions* (3rd ed. RMMLF, Westminster 2010) 546.

27 Bernard Taverne states that '*Inasmuch as the licence or contract will stipulate that the petroleum operations should be carried out according to good oil field practice, it follows that the operator is equally obliged to carry out the operations in this manner. (…) The operator is responsible for maintaining an adequately staffed organisation enabling him to fulfil his duties. If a party acting as operator is an affiliated company such party operator is allowed to receive and pay for technical and other assistance and services from his parent company or other affiliated companies.*' Bernard Taverne, *An introduction to the regulation of the petroleum industry: Law, Contracts and Conventions* (Graham & Trotman, London 1994) 136.

28 Scott Styles, ´*Joint Operating Agreements*` in John Paterson, Greg Gordon (eds), *Oil and Gas Law: Current Practice and Emerging Trends* (DUP, Dundee 2007) 279.

If the Operator meets this standard of performance in the conduct of the joint operations, it will not be held exclusively liable for any loss or damages; instead, it will only be liable as per the percentage of its participating interest.[29] Even if the Operator fails to maintain this standard, a JOA's exculpatory clause commonly maintains the previously discussed restriction of liability,[30] except in two situations: gross negligence and reckless misconduct. "A common practice in the industry is to limit the operator's liability to acts and omissions which are grossly negligent."[31] In such cases the Operator will not be protected by the exculpatory clause except for unmeasured costs/losses like environmental and indirect losses.

Sixth, it is reasonable to suggest that large oil and gas companies would argue that the "no gain, no loss" principle should always apply and they would not feel comfortable signing a JOA that imposed additional liabilities on the Operator. Most international oil companies typically serve as Operators and non-operator Participants, depending on the projectBut their main concern is sole liability of the Operator as they often take this role. For this reason some JOAs might provide further protections for the Operator as they require an action or omission conducted by a senior supervisor of the Operator rather than anyone to trigger the sole liability of the Operator. [32] In addition, some JOAs might even determine

[29] Scott Styles states that "*The corollary of the principle that the operator qua operator is not remunerated for his services is that he will usually only be liable qua operator to the non-operators if he is responsible for 'wilful misconduct' or fails to maintain insurance … However, he will not usually be liable for an 'honest mistake,' a misjudgement or negligent act or omission.*" Scott Styles, "*Joint Operating Agreements*" in John Paterson, Greg Gordon (eds), *Oil and Gas Law: Current Practice and Emerging Trends* (DUP, Dundee 2007) 279.

[30] Charez Gonvala states that '*The joint operating agreement will set the standard to which the operator should reference to what other operators would do in similar circumstances.*' Charez Golvala, ´Upstream joint ventures – bidding and operating agreements` in Geoffrey Picton-Tubervill (ed.), *Oil and Gas: A practical handbook* (Globe Law and Business, London 2009) 45.

[31] Claude Duval et al., *International Petroleum and Exploration Agreements: Legal, Economic & Policy Aspects* (2nd ed. Barrows, New York 2009) 293.

[32] *See* AIPN JOA Clause 4.6 (D).

the type of costs or put a cap on the amount of losses the Operator accept to bear exclusively.[33]

Seventh and finally, the limitations on the Operator's liability apply only to the actions performed by the Operator under the authority expressly provided in the JOA. If the Operator acts outside the authority provided by the JOA, it is not covered by the exculpatory clause.[34]

These above-mentioned principles are commonly established in most JOAs around the globe, and the industry is fairly used to them. But the question remains regarding the interpretation and enforceability of these provisions as some of them might be challenged in courts.

With these understandings in mind, we can examine the *Reeder* decision to see how some courts may interpret a common exculpatory clause. This in turn will shed light on the concerns parties should be aware of before negotiating their JOAs.

33 ibid.

34 Peter Roberts, *Joint Operating Agreements: A Practical Guide* (Globe Law Business, London 2010) 156.

V. The Reeder decision: Texas further narrows operator liability

The proximate cause of the consternation noted above was the decision of the Supreme Court of Texas interpreting the scope of the exculpatory clause in *Form 610-1989 Model Form Operating Agreement* of the American Association of Professional Landmen (hereinafter AAPL Form 610-1989). The provision contained what appeared to be minor changes to the wording of prior form agreements. As we shall see, however, even minor changes can have enormous consequences.

The Texas Supreme Court acted on an appeal from a lower court decision, which had substantially affirmed a trial court judgment against an operator in a northeast Texas oilfield. In *Reeder v. Wood County Energy et al.,* 320 S.W.3d 433 (Tex. App. – Tyler 2010) ("*Reeder I*") the 12th District Court of Appeals for the State of Texas held that the AAPL Form 610-1989 exculpatory clause did not apply to breach of contract claims, and so the jury verdict awarding damages against the operator was affirmed. In *Reeder v. Wood County Energy et al.,* 395 S.W.3d 789 (Tex. 2012) ("*Reeder II*"), the Texas Supreme Court reversed the lower courts' decisions and struck down the award, holding that the "plain and ordinary" meaning of the exculpatory clause was broader than the lower courts believed. A brief discussion of the facts of the case is helpful to an understanding of its significance.

a. Background

In 1996, several investors formed a joint venture to explore and develop two adjacent and overlapping oil-bearing formations: the Forest Hill Field Harris Sand Unit ("Harris Sand") and the Forest Hill Field Sub-Clarksville Unit ("Sub-Clarksville").[35] In 1998, Wendell Reeder ("Reeder") acquired an interest in Harris Sand and became its Operator. In 2004, Reeder

[35] *Reeder I,* 320 S.W.3d at 439.

formed a company called Wood County Oil & Gas, Ltd. ("WCOG") in which he was a 45% owner, to hold his interest in Harris Sand.[36]

Reeder had no prior experience as an oilfield operator, and his relationship with the other venturers deteriorated over time. In 2003, Reeder refused to allow the Sub-Clarksville venturers access to any of the Harris Sand wellbores, despite language in the JOA that gave them the right to use the wellbores to draw from the Sub-Clarksville formation.[37] As Operator of Harris Sand, Reeder sought funds from WCOG for testing or repair of four wells; but the other owners of WCOG (who collectively held a majority interest in the company) denied his request. Eventually, the State of Texas suspended operations at Harris Sand.[38]

In 2004, Reeder sued the Sub-Clarksville venturers, claiming among other things that he had sole right to operate the Harris Sand wellbores and accusing them of pumping oil from Harris Sand in violation of the agreement. WCOG joined in Reeder's suit as plaintiffs against the Sub-Clarksville venturers. The Sub-Clarksville parties filed claims against Reeder and WCOG relating to the same wells, alleging among other things that Reeder, as successor in interest to the JOA, breached its terms by pumping oil from the Sub-Clarksville formation and falsely reporting it as coming from Harris Sand.[39]

Prior to trial, the majority owners of WCOG decided to change their litigation strategy. The company dropped its claims for damages against the Sub-Clarksville parties and sued Reeder for damages for his actions as operator, including loss of the Harris Sand unit. They also sought indemnity for any damages that might be awarded against WCOG on the Sub-Clarksville claims.[40]

---

[36] ibid.

[37] ibid, 439–440.

[38] *Reeder II,* 395 S.W. 3d at 791.

[39] *Reeder I,* 320 S.W. 3d at 440.

[40] ibid.

b. Trial proceedings

At trial, Reeder argued that if he was bound by the JOA at all, he was not liable for any breach of contract. He reasoned that the JOA's exculpatory clause protected him from liability except in cases of willful misconduct or gross negligence. The clause was taken from the AAPL Form 610-1989 language and provided in pertinent part

> Operator shall conduct its activities under this agreement as a reasonable prudent operator, in a good and workmanlike manner, with due diligence and in accordance with good oilfield practice, but in no event shall it have any liability as Operator to the other parties for losses sustained or liabilities incurred except such as may result from gross negligence or willful misconduct.[41]

The trial judge agreed with Reeder's position on the scope of his potential liability and instructed the jurors that to decide against Reeder they had to find he acted willfully or with gross neglect.[42] WCOG objected to the instruction and so preserved the issue for appeal.[43] Despite the instruction favoring Reeder, the jury returned a verdict against him; in so doing, they necessarily concluded that his conduct was the product of willful misconduct or gross negligence. Based on the jury verdict, the trial court entered judgment against Reeder, stripping him of his interest in the Harris Sand unit and ordering him to pay slightly more than $997,000 USD plus interest.[44]

c. The intermediate appeal

Reeder timely appealed to the Texas 12th District Court of Appeals.[45] He argued, *inter alia,* that the evidence was insufficient to support a finding

41 ibid, 444.

42 ibid, 443.

43 ibid, 444.

44 ibid, 440–441.

45 ibid, 441.

of willfulness or gross neglect.[46] The appellate court, however, found it unnecessary to decide that issue. Instead, it concluded that based on earlier case law the exculpatory clause did not protect operators against breach of contract claims. The court relied primarily on its own prior decision in *Castle Tex. Prod. Ltd. P'ship v. Long Trusts*, 134 S.W. 3d 267 (Tex. App. – Tyler 2003) (pet. denied). That case found no protection for the operator of an oilfield against breach of contract claims despite exculpatory language in the JOA taken from the prior (AAPL Form 610-1982) form contract, which provided

> [Operator] ... shall conduct and direct and have full control of all operations on the Contract Area as permitted and required by, and within the limits of, this agreement. It shall conduct all such operations in a good and workmanlike manner, but it shall have no liability as Operator to the other parties for losses sustained or liabilities incurred, except such as may result from gross negligence or willful misconduct.[47]

Because the appellate court had concluded the 1982 version of the exculpatory clause offered no protection from breach of contract claims, and found "no meaningful difference" between that version of the clause and the 1989 version, it concluded that the AAPL Form 610-1989 exculpatory clause offered no protection for Reeder against the breach of contract claims.[48] Because WCOG had timely objected to the jury instruction on the scope of the clause and the appellate court found the instruction was more favorable to Reeder that it should have been, Reeder lost his appeal.

According to the appellate court, it didn't matter whether there was enough evidence to prove Reeder acted willfully or with gross neglect because that was not the proper legal standard to use in evaluating his liability. All that mattered was whether he breached the contract.[49]

---

46 ibid, 445.

47 ibid, 444, citing *Castle Tex. Prod. Ltd. P'ship v. Long Trusts*, 134 S.W. 3d 267, 283 n. 4 (Tex. App. – Tyler 2003) (pet. denied).

48 ibid.

49 *Reeder I,* 320 S.W. 3d at 444.

Assessing the evidence under a conventional breach standard (which generally doesn't require proof of willful misconduct or gross negligence), the court found the evidence was sufficient to support the jury verdict and the judgment of the trial court.[50] It affirmed the award of damages against Reeder with only minor technical modifications.[51]

The appellate court decision was consistent with decisions by other Texas courts. In four previous cases, four different Texas appellate courts interpreted similar exculpatory clauses in the same narrow fashion, holding that evidence of willfulness or gross neglect was not required in a breach of contract claim against the operator.[52] Although there was one federal case that interpreting the clause more broadly,[53] that decision was not binding on Texas state courts.[54] The Texas Supreme Court had never addressed the issue; in fact, it refused to review two of the four prior cases where the question had been raised, letting the rulings in those cases stand.[55]

d. Appeal to the Texas Supreme Court

At first glance, it seemed that the judgment against Reeder was on solid legal ground. Nonetheless, he petitioned the Texas Supreme Court for review of his case and the court granted the petition, entertaining argument in February 2012. Six months later, the court rendered a decision

---

[50] ibid, 447–448.

[51] ibid, 453.

[52] In addition to the *Castle* case cited above, the Texas courts of appeal issued rulings narrowly interpreting the exculpatory clause in *IP Petroleum Co., Inc. v. Wevanco Energy, LLC*, 116 S.W. 3d 888 (Tex. App. – Houston 2003); *Cone v. Fagadau Energy Corp.*, 68 S.W. 3d 147 (Tex. App. – Eastland 2001) (pet. denied); and *Abraxas Petroleum Corp. v. Hornburg*, 20 S.W. 3d 741 (Tex. App. – El Paso 2000).

[53] *Stine v. Marathon Oil Co.*, 976 F. 2d 254, 261 (5th Cir. 1992).

[54] On questions of state law, U.S. federal courts sitting in diversity generally apply state law; but state courts do not generally apply federal law unless there is a federal question presented by the litigation. *Erie R.R. Co. v. Tompkins*, 304 U.S. 64, 78, 58 S. Ct. 817 (1938). No such federal question was asserted by Reeder.

[55] The *Castle* case and the *Cone* case, cited above.

in Reeder's favor, reversing the trial court jury verdict and the appellate court decision that affirmed it.[56]

After reciting substantially the same facts as the lower court,[57] the Texas Supreme Court noted that "the primary concern" of courts asked to resolve contract disputes is to "ascertain the true intent of the parties as expressed in the instrument."[58] Addressing this question, the court concluded that in one important respect the trial court was right and the appellate court wrong. The "plain and ordinary meaning" of the exculpatory clause, the Texas Supreme Court held, extended to breach of contract claims.[59] The jury instruction given by the trial court was proper, even though the court of appeals thought it was too favorable to Reeder.

In reaching this conclusion, the Texas Supreme Court noted that the AAPL Form 610-1989 exculpatory clause differed from its predecessors: whereas the earlier clauses covered only "operations," the 1989 language covered "activities."

Exculpatory clause language from AAPL Form 610-1989:	*Exculpatory clause language from AAPL Form 610-1982:*
Operator shall conduct its activities under this agreement as a reasonable prudent operator, in a good and workmanlike manner, with due diligence and in accordance with good oilfield practice, but in no event shall it have any liability as Operator to the other parties for losses sustained or liabilities incurred except such as may result from gross negligence or willful misconduct.	[Operator] ... shall conduct all such operations in a good and workmanlike manner, but it shall have no liability as Operator to the other parties for losses sustained or liabilities incurred, except such as may result from gross negligence or willful misconduct.

56 *Reeder II,* 395 S.W. 3d at 789. Most U.S. court systems only allow one appeal as of right; any further review is discretionary with the superior appellate court.

57 ibid, 791–792.

58 ibid, 794.

59 ibid, 795.

According to the court, the change in language made all the difference. Citing law review articles published in 2001 and 2005 suggesting the word “activities” gave the 1989 version broader scope than the previous word “operations,’ the court held the change in wording provided a “more expansive exoneration for the Operator” than before. The court reasoned that by using the newer clause, the JOA parties at Harris Sand and Sub-Clarksville must have intended to provide additional protection to the operator, thus shielding Reeder from mere breach of contract claims.[60] In order to prevail against him, the court held, the other parties had to prove Reeder’s willful misconduct or gross negligence.

Of course, under the trial court instruction, the jury necessarily concluded that Reeder *had* acted willfully or with gross neglect. But the Texas Supreme Court was just getting started. Even though the jury was properly instructed, the court concluded that the jurors reached the wrong conclusion. Under prevailing Texas law, a jury’s factual determinations must be upheld unless the evidence is so weak that no reasonable jurors could have reached the same conclusion.[61] Reviewing the trial evidence, the court decided the jury was wrong to find against Reeder because the evidence was insufficient to find either willfulness or gross neglect.[62] Accordingly, the court reversed the judgment as to the breach of contract damages against Reeder. In the end, he still lost his rights in Harris Sand, but the million-dollar judgment (inclusive of interest) against him for breach of his obligation as its Operator was entirely wiped out.[63]

e. Analysis

The Texas Supreme Court concluded that when the parties to the JOA agreed to the 1989 model contract, they intended its exculpatory clause would extend to breach of contract claims against the Operator. The court cited no any evidence supporting its conclusions: there was no

[60] ibid, 794.

[61] ibid, 795, citing *City of Keller v. Wilson*, 168 S.W.3d 802, 807 (Tex. 2005).

[62] ibid, 796.

[63] ibid, 797–798.

testimony by the parties or their representatives concerning negotiation of the JOA, no correspondence or other contemporaneous documentary evidence discussing the scope of the clause, and nothing about Reeder's understanding of the clause when he took on his duties as Operator of Harris Sand. The court could have remanded the case with instructions to take evidence on the parties' intent, but such extrinsic evidence is generally not required (and generally not admissible) when the terms of the agreement are clear and unambiguous.[64] By reversing the judgment of the trial court rather than remanding, the Texas Supreme Court necessarily found that the exculpatory clause of AAPL Form 610-1989 so clearly covered breach of contract claims that there could be no other reasonable interpretation of its scope.

The obvious rejoinder – that the parties had no reason to believe that exculpatory clause reached such claims because no Texas court had ever said so – was not addressed in the *Reeder* decision. In fact, the earliest authority relied on by the court was a law review article written in 2001, five years *after* the original parties signed the JOA and three years after Reeder became Operator of Harris Sand. To the extent the parties to the JOA had taken time to research the scope of the exculpatory clause or consult legal counsel regarding it, they would have found no authority warning them that the broad interpretation was correct.

As a practical matter, it is unlikely that the original JOA parties or Reeder gave the scope of the clause even the slightest thought. Certainly there is no evidence in the record that they did. Moreover, the language of the clause itself speaks to standards of care that could be interpreted to cover tort claims rather than contract claims, suggesting that the issue is not so clear-cut as the Texas Supreme Court suggests. Nonetheless, based on the substitution of the new language word "activities" for the prior word "operations," the court held that all the parties *must have known* contract claims were covered, even though no court in Texas had ever said so. That ruling is now binding law in all courts in Texas.

[64] *National Union Fire Ins. Co. v. CBI Indus., Inc.*, 907 S.W. 2d 517, 521 (Tex. 1995).

VI. Action post-Reeder

The *Reeder* decision controls not only cases brought in Texas state courts; it also must be applied by all federal courts sitting in diversity in that state and any other tribunal required to apply Texas law.[65] In 2014, the U.S. federal district court for the Southern District of Texas applied *Reeder* to dismiss claims against Chesapeake Exploration LP, the Operator in a joint venture based in the Barnett Shale.[66] To the extent that other breach of contract claims against operators in Texas are pending or may arise, potential plaintiffs will need to evaluate their position in light of *Reeder.* Although prior language exonerating operators from all but willful misconduct or gross negligence in "operations" is not a defense to breach of contract and a case alleging breach under a JOA using that language need not prove willfulness or gross neglect, a breach of contract claim under a JOA with the new "activities" language will have to do so. The case may be able to proceed even under the higher standard if the evidence of willfulness or gross neglect is sufficiently strong; but as Reeder and his business associates learned, the plaintiffs' odds of prevailing are markedly lower.

This takes us back to a relevant question raised in the wake of the *Reeder* case: why should would-be participants even bother with a JOA that may include onerous provisions that such as "non-consent penalties of 300% or more rather than the common law rule of straight cost recoupment, restrictions on assignment rather than free alienability of property rights, and the granting of liens for failure to pay costs" if operators are expansively insulated against liability?[67] This is not an entirely unreasonable query. The "golden age" of oil and gas development, in which "there was an assumption of mutual good faith among the

---

65 *Erie R.R. Co. v. Tompkins*, 304 U.S. 64, 78, 58 S. Ct. 817 (1938).

66 *MDU Barnett L.P v. Chesapeake Exploration L.P.,* No. H-12-2528 (S.D. Tex., Feb. 14, 2014) (mem. op.).

67 Averill & Sartain (n. 4).

members of a joint venture," is over.[68] Complex and detailed JOAs protect venturers against predation and, in some instances, may be the only plausible vehicle for vindication of their rights. But willfulness and gross neglect are very high standards: if an operator can now be absolved of responsibility for all of his contractual obligations (or at least shielded from any possible lawsuit) absent such egregious behavior, participants may be on very shaky ground. Some commentators suggest that former JOA parties may now prefer common-law co-tenancy in mineral rights.[69] Such co-tenancies provide for accountings, rights to the proceeds of the mineral estate, and duties of good faith that must be exercised by superior interest holders, including a good-faith duty to develop the resource.[70] In the post-*Reeder* world, one might ask whether the parties would get substantially the same rights without an agreement.

The short answer is "no." First: The world is not limited to Texas, and *Reeder* decision only binds courts obligated to follow Texas law. Even where the 1989 language absolving operators of liability for "actions" is part of the JOA, other courts may not choose to read the language as broadly as did the Texas Supreme Court. A participant in another jurisdiction is free to argue the Texans just got it wrong; and an operator who assumes he now has *carte blanche* to engage in cavalier treatment of the participants may be in for an unpleasant (and costly) verdict to the contrary.

Nonetheless, the *Reeder* case will provide ammunition for operators in future cases to argue that even where there is no binding precedent *requiring* a broad reading, there is now persuasive authority to do so. The *Reeder* decision may not mandate an operator-friendly result outside Texas, but as a decision from a jurisdiction with significant impact on the oil and gas industry, it may persuade tribunals that such a result should be rendered. It would therefore behoove participants who have not already

---

68 Eduardo G. Pereira, 'Protection against Default in Long Term Petroleum Joint Ventures' (Oxford Institute for Energy Studies, 2012), 2.

69 Averill & Sartain (n. 4).

70 David E. Pierce, 'Transactional Evolution of Operating Agreements in the Oil and Gas Industry' (Rocky Mountain Mineral Law Foundation, 2007).

reviewed their JOA's exculpatory clause to do so as soon as possible, to ascertain what rights they may have – or not have any longer – in the event of an operator breach.

Second: Relying on mineral co-tenancy rights rather than a JOA is an inherently risky proposition. Those rights, to the extent they exist at all, can vary substantially from one place to the next. Each party would have to conduct extensive (and possibly very expensive) research into the applicable law to know how the mineral estate value would be calculated, adding a layer of complexity and risk onto an already-uncertain business assessment. With added risk comes added cost for insurance, reserves, and other forms of contingency planning and mitigation, and fewer opportunities in which the would-be venturer might afford to participate. The *Reeder* decision doubtless came as an unpleasant surprise to many; but it is difficult to see how a state court unconstrained by contract language and given unfettered discretion to realign the parties' rights according to its own notions of common-law tenancies would be better.

In fact, the industry has already spoken decisively on this point. Even before the advent of the modern form JOA, oil and gas professionals recognized that co-tenancy rights were not enough to order the affairs and structure of an enterprise as inherently complex, expensive, and risky as oil and gas field development. The earliest form contracts, starting with the 1956 AAPL Ross-Martin form, drew on more than a dozen existing JOA contracts.[71] The cost and complexity of hydrocarbon development today – where the fiscal, legal, and technical regimes are far more intricate and demanding than 60 years ago – may provoke a certain nostalgia for the past, but there is no plausible way to turn back the clock.

Third: It may be difficult to find anyone qualified and willing to be an operator in the absence of clearly-defined obligations and authority. Qualified parties may not choose to accept uncertain and potentially broad liability in an environment where there is no JOA to protect them – and this risk would likely be compounded in the absence of any tools (such as default provisions) to enforce compliance and cooperation of the parties who would have been non-operator participants in a JOA. Given

[71] ibid, 14.

that operators will likely always insist on some level of exculpation, the key for would-be participants is to negotiate better exculpatory clause language, or conduct better due diligence regarding the proposed operator – or both.

Moreover, the risk to participants from their peers' malfeasance may be at least as great in the absence of a contract as the risk from the operator. A "defaulting party may be happy to be losing its participating interest if the liabilities are greater than the value of the assets," as typically happens during the decommissioning process or when the resource is underperforming.[72] Even where the JOA does not provide the expected protection against one party, it can still reduce risk as to the others.

Finally: without the structure and clear lines of authority created by a JOA, third parties may be reluctant to do business with the venture. Without a single entity speaking on behalf of the venture, their risks would multiply without any corresponding upside. Though there would still be businesses willing to provide goods and services for development of the resource, the price would have to be scaled up to reflect this increased risk. Insurance for all parties would likely become vastly more expensive, if it could be obtained at all. A JOA may not cure all the ills that can beset a joint venture but still be worth having.

72 Pereira (n. 68), 14.

VII. Conclusion

In private business, what matters is profit,[73] and accurately estimating the likelihood of profit from a given enterprise can make the difference between successful businesses and those that fail. The *predictability* of rights and obligations can be more important than their *substance*, because companies will review the available opportunities, price their participation, and choose their ventures accordingly. If a proposed JOA contains language like AAPL Form 610-1989 the would-be participant deems too onerous, they can either insist on amending the language or refuse to be part of the venture. From this perspective, the final decision in *Reeder* was problematic not because it allowed the Operator of Harris Sand a far-reaching defense against liability, but because it gave him a defense that was broader than the courts were previously willing to give. The other parties could with some justification say they were not able to price their risk properly because the authorities relied on by the Texas Supreme Court in 2012 did not exist when they entered into the JOA in 1996, or when Reeder became Operator two years later.

There may today be other parties in similar positions: with contracts whose exonerations for the operator are now different from what they expected. In the wake of the *Reeder* decision, they must reassess their liability and reprice their rights and obligations accordingly. If the risk is too great, they need to reinsure or sell their interest. The JOA remains a valuable tool for spreading risk and reward, even if the balance has shifted for some in a post-*Reeder* world.

[73] ibid, 1.

Transfers of interest in Joint Operating Agreements

The risks associated with pre-emption rights: from a contractual, legal and political perspective

Aina Gómez Picanyol[1]

1 Lawyer at Clifford Chance, S.L.P. She holds an LLM degree in Professional Legal Practice from the UPF – Barcelona School of Management and an LLM in Maritime Law from the Scandinavian Institute of Maritime Law, University of Oslo.

Contents

1 INTRODUCTION 99
1.1 Aim of study 99
1.2 Method, sources and delimitation 100
1.3 Disposition 101

2 PRE-EMPTION RIGHTS IN JOA 102
2.1 Introduction to JOA 102
2.2 Nature of pre-emption rights and its logic 104
2.3 Formulations of the rights and their encumbrances 107
2.3.1 Matching rights 107
2.3.2 Right of first refusal 110
2.4 Conclusion 111

3 IMPORTANCE OF THE DRAFTING PROCESS: THE WORDING OF THE CLAUSE MATTERS 113
3.1 Hindrances of specific transactions' mechanic 113
3.1.1 Non-Cash consideration 114
3.1.2 Package Sale 121
3.1.3 Two-step transaction 128
3.2 Detailed wording enhances predictability: The Santos v Apache case 132
3.2.1 The Spar JOA 132
3.2.2 Analysis of the pre-emption provision 133
3.3 Conclusion 135

4 THE INTERFERENCE OF THE GOVERNING LAW 137
4.1 Adjusting the provision to the governing law 137
4.1.1 General 137
4.1.2 Application to rights of pre-emption 139
4.1.3 Conclusion 141
4.2 Government's rights of pre-emption 142
4.2.1 Kazakhstan 142
4.2.2 Angola 146
4.2.3 Norway 148
4.2.4 Conclusion 149

5 CONCLUSION 151

1 Introduction

The oil industry is no doubt facing challenges following the low crude price that since mid-2014 has affected the market. This has likely increased the need to monetize assets, vertically integrate businesses or seek other companies (even competitors) for the purpose of increasing market share as well as technical expertise. As a consequence, mergers and acquisitions in the oil industry have increased. Participating interests in petroleum projects are also transferred among actors through sale, assignment, encumbrance or other disposition of rights and obligations.

Successfully managing a transfer of a participating interest can be very challenging. Recognizing some specific issues early on in a deal might simplify the process and drive these deals for success.

One of the key elements to take into consideration is rights of pre-emption. This preferential mechanism is commonly found in Joint Operating Agreements (JOAs) in order to grant existent parties to the petroleum project a preferential right to acquire the interest being transferred by one of their co-venturers. However, the inclusion of pre-emption clauses requires careful considerations by the parties to the JOA about the risks associated with pre-emption rights. It may very well be that standardised clauses do not cover innovative methods of transferring interests to parties outside of the JOA. In addition, the interference of the governing law in the construction and interpretation of the contract as well as the hindrances associated with political contexts where the contract area resides will be of most importance when a transfer of interest is to take place.

1.1 Aim of study

The aim of this research is to understand the risks of including preferential rights in JOAs, with a focus on how the contract drafting process, the governing law and political context affect transfers of interest. This paper analyses more in detail pre-emption rights, in contrast to other

types of preferential rights (i.e. right of first refusal), despite the fact that on some occasions, reference to both of them will be made.

While the research could have transferable values for other sectors, it focuses on the oil and gas sector by answering the following research question: **which are the risks associated with pre-emption provisions that actors ought to consider when addressing transfers of interest in JOAs?**

The underlying research question drives the author of this paper to examine:

- What is the reason behind for including pre-emption provisions in JOA, or for excluding them from the contract?
- How should a pre-emption provision be written and what does the 'triggering event' stand for?
- How would the governing law affect the construction and interpretation of such clause?
- How would the political context where the project is developed affect the transfer of interest?

1.2 Method, sources and delimitation

This paper examines both primary and secondary legal sources from different jurisdictions.

The introduction to pre-emption rights in chapter two, has an academic approach, hence, the main sources that have been used by the author are books and articles. While the books provided information about the rights of pre-emption, the articles provided opinions. As a result, a descriptive-critical text will be provided

The research of the drafting process in chapter three is mostly conducted through the analysis of case law. Given the little legal authority in civilian legal systems regarding the application of pre-emption rights,

only cases from different jurisdictions within the US and a few from Australia will be discussed[2].

As regards to the interference of governing law in the first section of chapter four, the author decided at an early stage to keep an academic approach that served to illustrate the point that the contract is not self-sufficient. The aim of this paper goes beyond a mere legal analysis and also highlights political implications of pre-emption rights. Section two of chapter four concerning the government's rights of pre-emption focuses on Kazakhstan, Angola and Norway where the State have secured its right of pre-emption but used it very differently. The research is conducted through the comparison of primary sources of law in each country, supplemented by industry reports and experiences from legal practitioners.

1.3 Disposition

This paper is structured in three main chapters in addition to the introduction and the conclusion. Chapter two examines the nature of pre-emption rights, the different formulations and the pros and cons associated with them. Chapter three, reflects on the importance of the language given to the pre-emption right provision by the drafting parties. In doing so, different problematic scenarios, which are likely to happen during the life cycle of a petroleum project, will be analysed through case law. Chapter four is structured in two sections. Section one focuses on the interference of the governing law to the JOA, distinguishing between the approach followed in the civil and the common law tradition, in respect of the principle of good faith. Section two discusses the rights of pre-emption, as a tool for governments in financial and political decision making.

2 It should be noted that no pre-emption rights are found in the UKCS (United Kingdom Continental Shelf) since 2002, therefore the author decided not to analyse cases from this jurisdiction. See p. 17 in this paper.

2 Pre-emption rights in JOA

2.1 Introduction to JOA

Joint Operating Agreements (JOAs) are found in the context of upstream petroleum projects, most commonly where the government has awarded a concession which grants the right to explore for and produce petroleum to a group of persons that have come together for that purpose in a joint venture[3]. The relationship between these parties towards the Government will mostly be governed by the Licence[4]. The JOA is the document that sets out the rights and obligations of the parties amongst themselves[5]. According to this, the *vertical relationship* between the grantor of the concession and the concession-holders will be governed by the terms of the concession whereas the *horizontal relationship* of the participating parties will be detailed in the JOA[6].

In the context of petroleum projects, where multiple parties collaborate together, the structure chosen by them to organise their participation (i.e. incorporated and unincorporated joint ventures) in a specific project is an essential aspect of the latter. Joint operating agreements are commonly found in the context of unincorporated joint ventures[7].

Under an incorporated joint venture, there will usually be a limited liability company –called joint venture company– where the parties will issue shared capital. This company will be the holder of any necessary concession and the relationship of the shareholders in the Joint Venture

3 This is not always the case, where petroleum exploration and production projects are not very complex both from a technical and financial perspective, a single company may be the only concession-holder without entering in a joint venture with other companies in order to perform the concession.

4 Despite this being the case in most western countries, it should be stated that other forms can be seen in developing countries.

5 Martyn R. David, "*Upstream Oil and Gas Agreements*", London Sweet & Maxwell, 1996 at p. 13.

6 Roberts Peter, "*Petroleum Contracts: English Law and Practice*", Oxford University Press, 2013, at para 5.84.

7 Exceptionally, they may have a mixture of these two.

Company (that is, the parties that collaborate together) will be governed by the shareholders' agreement[8].

In contrast, where a petroleum project is undertaken under an unincorporated joint venture, the parties will not incorporate a separate company as a vehicle which represents their interests, but the relationship between them will be represented by a contract (as regards to upstream petroleum projects, that will be the JOA). Accordingly, when this structure applies, there will be a determined number of companies which will be the holders of the concession by the government (e.g. through the state agency[9]).

Although pre-emption rights are not incorporated into JOAs as frequently as in the past[10] and some states have on occasion caused them to be removed from certain JOAs (e.g. UK)[11], they are still commonly found in JOAs (in the context of incorporated and unincorporated joint ventures, respectively), and all the parties should be familiar with these provisions and understand how these may affect their business.

There are certain model forms that can be considered by the parties at the time of drafting the JOA. This is in most cases the starting point which can (and should) be amended to meet the interests of all the parties involved and the particularities of their petroleum project (e.g. the pre-emption rights provision is an example of an aspect to consider whether to include it or not in the contract).

---

8 ibid at p. 90.

9 ibid at p. 91.

10 Martyn (n 5) at p. 27; Sweeney David H, "*Oil and Gas Joint Operating Agreements: A Comparative World-wide Analysis*, LexisNexis, 2015 at para 10.03 [1]: "*the use of these provisions in joint operating agreements, at least in North America, has decreased since the 1990s due to the industry's experience with acquisitions and divestitures and the recognition that each party will probably be a seller at some point in an asset's life cycle. In relatively low-cost, low-risk North American onshore projects, preferential purchase rights and similar provisions look more like economic opportunism than the protection of the legitimate self-interest of a solvent party that took the risk of exploring and developing a prospect. Outside of the North America, and with respect to offshore projects, there is a more persuasive basis for the existence of these provisions, as this type of project typically involves greater cost and risk and fewer transfers from the original contracting parties*".

11 Gordon Greg and Paterson John, *"Oil and Gas Law – Current Practice and Emerging Trends"*, Dundee University Press, 2007, at p. 394.

A model form reduces the transaction costs and increases efficiency by limiting the scope of the negotiations[12]. Rarely a bespoke agreement form is drafted from a standing start[13]. It is not the aim of this paper to highlight the different variations between the model forms[14] but the most widely used JOA standard model forms are the following: AIPN Model; OGUK Model; AAPL Model; CAPL Model; RMMLF Model; The Greenlandic Model; The Norwegian Model and; AMPLA Model.

2.2 Nature of pre-emption rights and its logic

The interests of a party in the concession, the JOA and as a whole, the petroleum project constitute a valuable asset[15] (referred as, the participating interest). During the lifetime of a JOA different scenarios are likely to happen: fluctuation of the economic value of the project, discrepancies between the parties, among others. As a result, a party might wish to transfer its interests to another party (either to another participant in the JOA or an external third party).

A JOA represents a 'collaborative effort'[16] between two or more parties. Each of these, at the time of considering whether to enter or not into the JOA most likely took into account the financial and technical capacity of each other party to perform the commitments under the JOA, given the joint and several liability that is imposed in respect of the obligation to perform the concession. Therefore, it is reasonable that the transfer of the participating interest is one of the most sensitive issues in JOA.

Parties in a JOA are, over the years after its creation, likely to change. In other words, the interests in the petroleum project may change hands, and therefore, care must be taken at the time of negotiating the JOA of the

---

12 Roberts Peter, "*Joint Operating Agreements*", Third Edition, Global Law and Business, 2015 at p. 21.

13 Roberts "*Petroleum Contracts: English Law and Practice*" (n 7) at p. 363, para 8.21.

14 Interesting from the perspective of the treatment given to the non-operators position and their major concerns, read Pereira G Eduardo, "*Joint Operating Agreements: Risk control for the Non-operator*", Globe Law and Business, 2013.

15 Roberts "*Joint Operating Agreements*" (n 12) at p.147.

16 ibid.

viability of including pre-emption rights which limit the free tradability of the interest to a JOA and more importantly, the specific wording used in the provision.

Pre-emption rights are considered one of the most delicate issues when negotiating a JOA[17]. They operate where the interests in a JOA are held by multiple parties who have expressly agreed on a pre-emption right regime and at one point one (or more) of the parties decides to transfer its participating interest. These rights are intended to restrain the transfers of interests within a JOA, resulting –if exercised– in an internal economic reallocation of interests between the existing parties to the contract[18].

Changes of control are generally excluded from the application of provisions restraining transfers of interest[19]. This means that the shareholding interest of a person in a party to the JOA (this latter holding the participating interest in the petroleum project) may be transferred to a third party, such that the pre-emption right in respect of the participating interest is not triggered[20]. However, depending on the wording of the clause, pre-emption rights may also comprise that superior interest level or be regulated in a change of control provision[21], see for instance the AIPN 2012, which contains an optional provision that results in pre-emption rights applying to change of control transactions, as well.

As will be further developed below, pre-emption rights may be formulated in different ways: from fairly simple requirements to notify in advance an intended transfer thereby allowing the other parties to propose offers that may (or may not) be accepted by the party proposing an assignment, to rights to pre-empt (or take over) a negotiated transaction with another party[22].

It is reasonable to assume that the benefits of pre-emption rights are basically for the non-transferring parties. The preservation of the culture

---

17 Roberts "*Joint Operating Agreements*" (n 12) at p.156.

18 Roberts "*Petroleum Contracts: English Law and Practice*" (n 6) at p. 363, para 14.57.

19 Sweeney (n 10) at para 10.03 [4].

20 Roberts "*Joint Operating Agreements*" (n 12) at p.148.

21 ibid at p. 364, para 14.65.

22 *See* 'right of first refusal' and 'matching right' in section 2.3 of this paper.

and cohesion of the original joint venture is sometimes mentioned as one of the benefits of this clause. However, this intention is sometimes exaggerated. As some authors suggest[23]: "*This [...] is less obviously applicable where the JOA is of an age where subsequent transfers of interests have taken place and many, or even all, of the original parties have long since ceased to be associated with the JOA, and yet the pre-emption rights continue to govern the JOA.*"

It also rewards the original parties to the JOA in making the initial investment into the petroleum project, through granting those parties a preferential right to increase the level of their interest if they so decide[24]. In other words, pre-emption rights assure the original parties to a JOA that those risks, which they undertook in conducting exploratory operations, will be rewarded insofar they will be able to acquire additional interests in the lease in preference to third parties that did not undertake such risks[25].

In exercising this right, they can avoid the entrance of external parties with a different ideology from that of the current parties or that may lack the financial or operational capacity to bear its share of costs[26].

This right can also apply not only to block the entrance of an external party but to prevent the transferor from transferring all its participating interest to the same partner party (within the JOA), resulting in a high combined participating interest. How far this right is extended will depend on the wording used by the parties in drafting the clause.

---

23 Roberts "*Joint Operating Agreements*" (n 12) at p.157.

24 Hargrave J. In Beaconsfield Gold NL v Allstate Pty Ltd: "*Pre-emptive rights are usually included in resource joint venture agreements. Give the importance of the identity, financial capacity and reliability of the participants in a joint venture, pre-emptive rights operate to ensure that existing participants are empowered to exclude new participants by purchasing the outgoing participant's interest if they so desire. They also permit a joint venturer who may take the view that it has expended a significant amount of money in a high risk area to have an opportunity to increase its interest if another joint venture desires to withdraw from the joint venture. This allows an enhanced opportunity to reap the rewards from past-taking expenditures*".

25 Poitevent Edward B. and Hewitt Christopher L., "*Preferential Rights, Rights of First Refusal and Options: the whys and wherefores*", American Association of Petroleum Landmen New Orleans, Louisiana, 2000 at p. 2, citing *Questa Energy Corp. v. Vantage Point Energy, Inc., 887 S.W.2d 217, 222;* and Sweeney (n 10) para 10.03 [1].

26 Conine Gary B., "*Property Provisions of the Operating Agreement - Interpretation, Validity, and Enforceability*", 19 Tex. Tech. L. Rev., 1988, at p. 1317.

2.3 Formulations of the rights and their encumbrances

A number of terms, such as rights of pre-emption[27], are used to refer to a preferential right mechanism[28], each of these terms may have its specific mechanic.

This part describes the two main formulations of preferential rights i.e. matching rights (which are equivalent to pre-emption rights) and right of first refusal. Notwithstanding the explanation below, it is important to bear in mind that, in practice, the specific wording of the clause could bring to a hybrid of these formulations.

2.3.1 Matching rights[29]

According to this formulation, when the party that wishes to transfer its participating interest has negotiated the transfer with the transferee and these two have agreed on the commercial terms of the transaction, including the price payable for the proposed sale of its interests, the transferor is obliged to notify each of the non-transferring parties of those negotiated terms and the identity of the proposed transferee (known as, the pre-emption notice)[30], and the latters will have, for a defined period of time[31], the right to acquire the participating interest on the same terms. If one of the non-transferring parties or some of them decide to exercise their right, the third party will be set aside and they will acquire the transferor's interest on the same conditions as the third party.

---

27 Poitevent and Hewitt (n 25) at p. 1: *other nicknames include "option of first refusal", "preemptive rights", "preemptive option"; "first option" and "conditional or contingent right".*

28 idem.

29 This formulation can be seen in AAPL JOA 24.2; AIPN JOA 12.2.F; AMPLA JOA 14.3; CAPL JOA 24.01B.

30 The AIPN form requires a copy of the actual agreement be distributed to the preferential right holders.

31 Failure to exercise this right within the prescribed period constitutes a waiver of the pre-emptive right.

It is a right to acquire the interests 'on the same terms available to the third party', not at an increased price or on terms to be negotiated[32]. According to this, the interested party must respond in unequivocal terms[33] and any attempt to modify the terms of the sale in the exercise of the option will constitute a rejection of the offer[34]. Thus, pre-emption rights essentially allow non-transferring parties to step into the shoes of the potential transferee and acquire the transferor's interest.

The pre-emption process implies that the non-transferring parties must be provided with the amount of notice specified in the pre-emption clause and the sale to the third party may not be closed prior to the right holder's rejection of the offer to acquire the transferor's participating interests or the running of the notice period[35].

If there is more than one party interested in exercising its right, the transferor's interests will be allocated pro rata to their participation in the JOA.

As the reader may anticipate at this point, this formulation has the disadvantage of discouraging prospective assignees who may be reluctant to spend time, money and effort negotiating a transaction if they can be then pre-empted by the other non-transferring parties to the JOA[36]. A soft formulation of this right would require the transferor to approach the other parties to the JOA as soon as the principal terms have been agreed with the prospective transferee (referred as, the partially negotiated agreement) or to obtain a waiver in the first place. However, others do

---

32 Conine (n 26) at p. 1323.

33 Poitevent and Hewitt (n 25) citing Conine (n 25) at p. 1563 *"In some cases, however, the rightholder's acceptance will be valid despite minor or insubstantial variations from the original offer. In these situations, some courts have recognized limited exceptions to the strict conformity requirements of the "unequivocal acceptance rule." See, e.g., West Texas Transmission, L.P. v. Enron Corp., 907 F.2d 1554 (5th Cir. 1990). While the Fifth Circuit has not provided a hard and fast rule regarding what constitutes an insubstantial variation, it appears that the court will invoke the exception when a seller imposes an offer upon a rightholder (1) that is commercially unreasonable, (2) that is offered in bad faith, or (3) that is specifically designed to defeat the preferential right."*

34 Conine (n 26) at p. 1323, citing Hutcherson v. Cronin, 426 S.W.2d 638, 64.

35 Poitevent and Hewitt (n 25) at p. 5.

36 Taylor Michael P.G, Winsor T P and Tyne Sally M, "*The Joint Operating Agreement: Oil and Gas Law*", Longman 1989 at p. 61.

require the transferor to agree final documentation with the prospective transferee before giving the other parties their right to match the deal (referred as, the fully negotiated agreement)[37].

Sometimes the transferor wants to evade the exercise of the pre-emption right by the non-transferring parties and, consequently, does not give a clear and/or true notice of the agreed terms so that a party wishing to match them find it hard to do so. However, the transferor bears then the risk of that notice being deemed void for not providing full and transparent disclosure. It would be more difficult to challenge the validity of the pre-emption notice when the revealed terms actually reflect the negotiation undertaken by the parties, but turns out to be disproportionate and outlandish, because as long as the transferee is capable of matching these terms, the process would indeed be valid[38].

The exercise of pre-emption rights is said to affect the free transferability of petroleum project interests, as it involves additional costs associated with their exercise, such as money and time[39]. At the same time, even when the pre-emption system is procedurally simple and the notice period short, the mere existence of pre-emption rights can be very discouraging for potential transferees who know that the outcome of their costly negotiations to achieve beneficial terms can be used to co-opt the deal for another party to the JOA[40]. In that sense, the negative impact is more for the buyer than for the seller, since the latter will receive the same consideration for the asset on the same terms[41].

Moreover, this certainly impacts the market value of the interest subject to these rights. As Sweeney says: "*(pre-emption rights) chill the interest of potential purchasers, which can decrease the number of willing bidders and the size of offers*"[42]. Barry Richard clarifies it by explaining that when a potential buyer wants to acquire the participating interest of

37 ibid at p. 61 and 62.
38 Roberts "*Joint Operating Agreements*" (n 12) at p. 158.
39 ibid at p. 157.
40 Poitevent and Hewitt (n 25) at p. 2.
41 Gordon and Paterson (n 11) at para 14.36.
42 Sweeney (n 10) at para 10.03 [1].

a party to a JOA and makes a bid that can yield it a worthwhile profit, if that is certainly true, that bid will probably be pre-empted. Contrarily, if the offer is not pre-empted by the other co-ventures, this could be a sign, without being exhaustive, that a too high price has been paid for the participating interest. For this reason, many companies avoid bidding against a pre-emption right[43]. As a result, the party that wants to transfer its interest will get fewer offers and most likely, a lower price.

In light of the above, some states have on occasion caused them to be removed from certain JOAs. That is the case in the United Kingdom. The UK Government perceived, by the end of the twentieth century, pre-emption rights as a barrier to free trading of participating interests in JOAs and as an element which delayed and in some occasions prevented the introduction of new founds and resources into the UKCS. The Government was concerned that pre-emption rights clauses under JOAs were discouraging new entrants' participation in the North Sea and decided to stimulate the industry by adopting new pre-emption arrangement ("Master Deed") in order to promote and facilitate asset transfers under existing licences and give buyers increased confidence and clarity. By the time of the 20th offshore round in 2002 UKCS (licences granted in July 2002) JOAs that contained a pre-emption right provision had to be approved (which would not happen without justification thereof[44]) and in all instances the pre-existent JOAs had to follow the Master Deed model. As a result, new JOAs do not contain pre-emption provisions.

2.3.2 Right of first refusal

Under the right of first refusal, the transferor will be obliged to give notice to each of the non-transferring parties of its intention of transferring its

43 Roberts, "*Petroleum Contracts: English Law and Practice*" (n 6) at p. 367, para 14.84: "*these concerns are sometimes exaggerated, but the existence of pre-emption rights in a joint operating agreement may be sufficient to put off a possible buyer which has more tan one investment opportunity to choose form*".

44 Gordon Greg and Paterson John (n 11) at p. 295, ft. 19: "The Open Permission (Operating Agreements) granted by the Secretary of State on 18 December 2002 allows automatic approval of new JOAs for licences granted after 1 July 2002 which do not contain pre-emption arrangements (…)".

interest and either give them an outline commercial offer for its interests or invite them to make their best offer. If the transferor makes an offer, the price can be determined on the market value of the interests or be based on a reasonable monetary value ascribed to them[45].

If one or some of them are interested, they have an exclusive right to negotiate a transfer of those interests in their favour. As seen above, if there are more than one party interested in acquiring the transferor's interests, these will be allocated in the proportion the interest that each party has in the JOA.

If the parties to the JOA are unable to reach any agreement, the transferor will be free to seek a transferee outside the parties, but subject to a limitation: the external agreement cannot be 'materially different'[46] from that offer given to the non-transferring parties or may not sell to a third party for a lower price than that offered by the non-transferring party[47]. According to this, the terms of the transaction with the third party must be equal or more favourable to the transferor than those offered by the other parties to the JOA[48].

Non-transferring parties to the JOA sometimes find themselves that they are simply used to verify or set a price which may actually help the assignor to market the interest to third parties at higher price[49].

2.4 Conclusion

All in all, when reflecting on transfers of interest, Martyn explains that "there are two main (and conflicting) trains of thought (...) on the one hand that the License is an asset and should be, therefore, freely tradable

45 ibid at p. 363, para 14.99.

46 Roberts, "*Joint Operating Agreements*" (n 12) at p.160.

47 Walker David I., "*Rethinking rights of first refusal*", Discussion Paper No. 261, Harvard Law School Cambridge, MA 02138, at p. 10.

48 Taylor, Winsor and Tyne (n 36) at p. 62.

49 Roberts, "*Petroleum Contracts: English Law and Practice*" (n 6) at p. 363, para 14.102; Taylor, Winsor and Tyne (n 36) at p. 62.

and, on the other hand, that the Joint Venture is a group relationship that should be protected[50]".

If a JOA is viewed primarily as a relational contract[51], like a traditional partnership, with a significant element of *delectus personae* then, pre-emption right provisions[52] would appear to be reasonable because a party to a JOA is not just buying equity in a project, it is also becoming liable for its share of expenditure, and the rest of the JOA participants would like to be reassured as to the solvency of the incoming member. However, if one views the JOA primarily as a proprietary contract granting a right to restrain interests in production from the area of operations, then pre-emption rights can be seen as unjustifiable restrain[53]".

When considering the incorporation of such provisions, drafting parties should weigh their interests in the project, bearing in mind that most parties might, at some point during the life cycle of the contract area, be a transferor. Therefore, the language of the provision, if included in the JOA, should try to balance both divergent interests (of the transferors and non-transferring parties) and provide for an equitable mechanism for when an assignment of interest is to take place.

---

50 Martyn (n 4) at p. 26.

51 For a discussion, see Gordon and Paterson (n 11) at p. 273-301.

52 As this chapter shows, the rights of pre-emption can adopt different formulations that will limit the transfers of the participating interests in one specific manner. On the following chapters, different language, such as: "*right of first refusal*", "*right of first offer*", "*preferential right*" will be used interchangeably to refer to the pre-emption right mechanism that has been introduced here, bearing in mind that their specific application could be slightly different. See subsections 1.3.1 and 1.3.2 above.

53 Gordon and Paterson (n 11) at para 11.11.

3 Importance of the drafting process: the wording of the clause matters

In the previous chapter it has been explored what pre-emption rights are, the logic behind them, the main formulations and the disadvantages associated with them. That overview highlighted the importance for the parties to reflect on different pros and cons before including pre-emption rights provisions, as opposed to blindly incorporating them into their contracts.

In this chapter, we will assume that the decision has been made towards the incorporation of such clause and, the drafting process of these clauses will be analysed more in-depth. When drafting these provisions, parties sometimes use boilerplate language found in sample agreements, such as the AIPN Model Form, without recognizing the impact that such wording will have at the time of disposition of their participating interests. As will be studied in this chapter, the wording used in a pre-emption clause is very important and parties should bear in mind that each clause will need to be looked at very carefully when drafted.

3.1 Hindrances of specific transactions' mechanic

Three problematic scenarios (namely, non-cash consideration, package sale and two-step transaction), which are the origin of many disputes, will be examined below with the aim to illustrate the importance of the drafting process. The methodology followed consists on: (i) description of hypothetical scenarios that could potentially result in a dispute between the parties, (ii) explanation of different aspects that could be taken into account by the parties when drafting their contract in order regulate such scenarios (iii) commentary on certain cases to illustrate the disparity among courts from different jurisdictions within the US when a dispute arises and the clause does not provide a solution or the wording is not clear enough.

3.1.1 Non-Cash consideration

3.1.1.1 Hypothetical Scenario and concerns

The two main examples that can be found in this section are:

i) Company A is a party to a JOA 1 and wishes to transfer its participating interest to party B, which is a drilling company, in exchange for party's B performance of a drilling-related service.

ii) Company C is a party to JOA 2 and company D to JOA 3 and they wish to swap their interests in a single transaction, whereby party C acquires party D's participating interest in JOA 3, and Party D obtains Party C's participating interest in JOA 2.

When the transaction does not have the configuration of an outright sale of an interest for cash, but instead presents a more complex structure with a non-cash consideration, such as a service or swap of properties, co-ventures to the JOA will never or rarely be able to match the consideration offered by the third party, being a particular service or an specific interest.

3.1.1.2 Clarification by the parties

The scenarios explained above show how a transferor and a transferee could avoid a deal being pre-empted by the other parties to the JOA. This aspect could, and should, be taken into account at the time of drafting the JOA and provide for a method by which a cash value can be attributed to the affected interests, such that the pre-emption rights can still be exercised by co-ventures[54].

Very often an indicative cash value of the interest will be allocated by the transferor, as part of the notice to be given to the non-transferring

---

[54] This was the case in ***Sanrus Pty Ltd and Ors v Monto Coal 2 Pty Ltd and Ors QSC 282 (2002).2d 1053 (1978).). Inc., that eflect on the following eventing the entrance of an unwanted actor) or commecial , since th, 2014***, where the pre-emption right clause contained a requirement that the offer had to be made for specific cash consideration. The Australian Court found the pre-emption notice sent by Monto Coal 2 Pty Ltd to sell its participating interest to be invalid, since it was not made for specific cash consideration as provided in the Agreement.

parties. Later on, these co-ventures may, during a period of time, be able to signal their objections regarding the validity of such valuation[55].

If no agreement concerning the valuation of the interests to be transferred is achieved by the parties, an independent expert can be appointed by them in order to settle the issue. The expert's valuation will be final and binding, which means that, if nothing to the contrary is stated by the parties into their contract, they will then be obliged to continue with the transfer at the price fixed by the expert[56].

The costs of that expert will be borne by either the transferor or transferees, according to the assessment result. That is, if the transferor has submitted an unreasonably high valuation, in contrast to that one assessed by the expert; it will bear the costs. Contrarily, if the transferees have raised unreasonable objections to the transferor's valuation to defeat the process, they will cope with that expense[57].

Nonetheless, it is as well for the parties to decide whether to include a 'get-out' provision by which they can decide not to proceed with the transaction, if the price assessed by the expert is too high (so the transferees cannot afford it) or too low (so the transferor prefers no to assign it)[58].

3.1.1.3 Judicial interpretation

When the contract is silent about this issue or the language is not clear enough, Courts will have to interpret the contract and determine the applicable solution. However, as will be seen below, Courts in different jurisdictions have addressed the issue with different results; some of them construe the pre-emption rights provision expansively, encompassing other agreements such as exchanges and farm-outs, whereas others will interpret it narrowly to merely include a sale (being a transfer of a participating interest in exchange for a price in money).

[55] ibid.

[56] ibid.

[57] ibid.

[58] ibid.

3.1.1.3.1 Examples of pre-emption right provisions interpreted narrowly

Where no obligation to allocate cash consideration is required in the provision, some Courts would see the unmatchable deal route as it has been intended by the parties to the JOA and, therefore, pre-emption rights will not be applicable in respect to a proposed transfer in exchange for non cash consideration.

In ***Panuco Oil Leases, Inc. v. Conroe Drilling Co.***[59] and ***LeBreton v. Allain-LeBreton Co.***[60] (hereinafter, *Panuco vs. Conroe Case* and *Le Breton Case*), the Texas Court of Appeal and the Louisiana Third Circuit Court of Appeal, respectively, held that pre-emption rights applied merely to sales, and hence, an exchange of one party's interests in consideration of an obligation to the other party or an exchange of an interest in one partnership for an interest in another partnership, were not considered a "sale"[61] and no pre-emption rights were triggered.

The pre-emption rights provisions read as follows:

> 1. (...) should the Operator desire **to sell** all or any part of its leasehold estates covered by this agreement, it will notify Owner as hereinabove provided of any bona fide offer that it has **to sell** such interest ... after the expiration of ... of its election **to purchase said interest at the price proposed**, then Operator shall be free **to sell** such interest (...)[62]. *Panuco vs. Conroe Case.*
> 2. (...) should any certificate holder desire **to sell** his share of the partnership or any portion thereof he shall first offer the same to

59 Panuco Oil Leasees, Inc. v. Conroe Drilling Co., 202 F. Supp. 108 (S.D. Tex. 1961).

60 LeBreton v. Allain-LeBreton Co. 631 So.2d 662 (La. App. 3 Circ. 1994). Clear and interesting review about the *LeBreton Case* in Williams Aimee L., "*Restrictions on Assignment (Consent to Assign, Preferential Right to Purchase and Maintenance of Uniform Interest Provisions)*", Institute on Mineral Law 49th annual 2002, at p. 229-230. and every stage of this thesis and for s of my life. ach and every stage of this thesis and for la meva vida. aquest nce and im

61 Below it will be discussed what is to be considered a "sale" for these Courts.

62 Panuco Oil Leasees, Inc. v. Conroe Drilling Co. (n 56) at p. 110, para VIII of the Farm-Out Agreement. Emphasis added by the author of this paper.

> the partnership through its management at its book value ... shall ... accept or reject this offer (...)[63]. *Le Breton Case.*

In *Panuco vs. Conroe Case*, there were two letter-form agreements between Conroe and Marine and Feldman and Marine, providing for an exchange of working interests, respectively, in consideration of Marine's agreement to drill a well deeper. The Court reasoned that under the language in the pre-emption right provision in the Farm-Out Agreement (*see 1. above*), those exchanges could not be considered "sales" and therefore Panuco never acquired any right of the option or right of refusal clause set forth in paragraph VII of the Farm-Out Agreement[64].

In *Le Breton Case*, the Louisiana Court took a step further and analysed what a sale was considered to be. In this case, there was a company called The Allain-LeBreton Company (the "Company") which was formed by members of two families, the Allains and the LeBretons. The LeBreton family at some point decided to transfer their interest in the Company in exchange for interests in the newly created LeBreton Family Partnership. The Court understood that transaction as an exchange, in contrast of a sale.

The Court held that the transaction did not fall within the wording of the pre-emption clause (which only applied to sales), and thus, no preferential rights were activated. The reasoning followed by the Court reads as follows:

> "The right of first refusal applies if a certificate holder wants to sell his share of the partnership. A sale is defined in La.Civ. Code art. 2.439 as: Art. 2439. Sale, definition
>
> *The contract of sale is an agreement by which **one gives a thing** for a price in current money, and the **other gives the price** in order to have the thing itself.*
>
> *Three circumstances concur to the perfection of the contract, to wit: the **thing sold**, the **price** and the **consent**.*

[63] Panuco Oil Leasees, Inc. v. Conroe Drilling Co. (n 56), at p. 666, art. 7 of the Partnership Agreement. Emphasis added by the author of this paper.

[64] idem at p. 115 at para 9.

> *An exchange is defined in La.Civ. Code art. 2660 as: Art. 2660. Exchange, definition*
>
> *Exchange is a contract, by which the parties to the contract give to one another, one thing for another, **whatever it be, except money;** for, in that case it would be a sale.*
>
> The transaction the LeBreton partners attempted was an exchange, not a sale. The right of first refusal does not apply to transfers (...)"[65].

These cases show how important clear drafting is when construing the contract. Had the wording been "transfer" instead of "sale" the ruling of these courts would have possibly been different. Both decisions place a lot of attention on the precise meaning of the language used, something that may appear extraneous under other jurisdictions (i.e. within civil law tradition), as will be explained in chapter 4.

3.1.1.3.2 Examples of pre-emption right provisions interpreted expansively

There are some Courts that have arrived to the very opposite conclusion and when the contract is silent about non-cash transfers, imposing the pre-emption right holder the obligation to match the third party's offer without any material variance, would be illusionary and render this right valueless. It would also permit the seller to always defeat the pre-emption right by requiring a unique property in exchange.

However, some Courts also recognize that by allocating an equivalent cash consideration of the property exchange offer (that is, offers which arguably leave the property owner "as well off" as does the third party offer, but which vary materially from it), would mean to impose a different contract by the Court and this would seriously infringe the right of the owner to dispose of the property. A balanced solution is therefore needed.

In ***Prince v. Elm Inv. Co., Inc***.[66], the Supreme Court of Utah had to consider whether the transfer of property from Elm (the transferor) to

---

65 LeBreton v. Allain-LeBreton Co. (57) at p. 666, emphasis added by the author of this paper.

66 Prince v. Elm Inv. Co., 649 P.2d 820, 826 (Utah 1982).

Boyer-Gardner (the transferee) in exchange for an interest in a partnership was considered a sale, and in such a case, if the offer from the buyer could be matched by Trolley, the other party to the agreement and holder of a preferential right.

As regards to the first issue, the Court said that for the purpose of the right of first refusal a sale would occur upon "*the transfer*

a) *for a value*
b) *of significant interest in the subject property*
c) *to a stranger to the lease,*
d) *who thereby gains substantial control over the leased property*"[67].

Since each of these four elements was met, the Court answered positively to the first question and the right of first refusal was activated:

"(a) the transfer was for value. (b) Because of its forty-nine percent interest in the Partnership[68]*, Elm transferred and Boyer-Gardner received a significant interest in the leased property. (c) Boyer-Gardner was a stranger to the Elm-Trolley lease. (d) Because of the terms of the Partnership, Boyer-Gardner gained substantial control (in effect, a veto power) over the leased property as a result of the transfer*"[69].

The second concern was more complex. Trolley had a right to acquire the property or an interest therein on terms that matched (or exceeded) those agreed with the prospective purchaser. The offer of the buyer, however, was an interest in a partnership, something "unique and that cannot be duplicated as a matter of law"[70].

In answering this question, the Court followed the reasoning in *Weber Meadow-View Corp. v. Wilde*[71], where the Court exemplified the problem as follows:

---

67 idem at 823.

68 Elm owned fifty-one percent and Boyer-Gardner owned forty-nine percent of the partnership.

69 Idem.

70 Idem at 824.

71 Weber Meadow-View Corp. v. Wilde, 575 P.2d 1053 (1978).

> "*[N]ot entirely without reason the argument that its holding would permit a property owner to demand one particular finger ring, an old hat, or any other unique item which the [promisee] could not obtain, and thus* ***defeat the promisee's right of first refusal****.*
>
> *(…) On the other hand, the property owner's prerogative to insist on payment with a unique object* ***is enforceable only so long as she acts in good faith and without any ulterior purpose to defeat the right*** *of the [promisee]*"[72].

The Court continued by saying that when a seller's decision is challenged as arbitrary or lacking good faith, the seller must articulate a "reasonable justification" for its actions. Whether or not a justification is reasonable is to be determined in light of the circumstances of each particular case[73].

According to this, the three elements required to the seller in order to transfer the burdened interest are: (1) to give the right holder notice of the third party's offer and its intention to accept it; (2) allow the right holder to submit a competing offer; (3) reject the offer, if any, only in good faith and on the basis of a reasonable justification.

The Court found the three requirements fulfilled, and therefore, recognized the validity of the transaction between Elm and Boyer-Gardner[74].

In this section it has been analysed a mechanism by which pre-emption rights could be circumvented. Legal authority, in different jurisdictions within the US, is not homogeneous. However, it has been shown that courts rely heavily on the language of the parties' agreement. This being the case, it is for the parties to guide the interpreter by providing a clear wording of their intention. For instance, some JOAs simply make

---

72 idem at 1054. Emphasis added by the author of this paper.

73 "For example, where the third-party offer includes a house that the seller intends to use as a personal residence, the seller's personal preference for that house as a basis for rejecting the promisee-rightholder's offer might be eminently reasonable. On the other hand, if the seller intended to use the offered house as a rental property, an explanation in commercial terms is probably required to meet the reasonableness standard".

74 A very similar result was reached by the Court in Matson v. Emory, 36 Wn. APP. 681 (Wash. Ct. App. 1984). In balancing the interests of the two parties in the dispute (i.e. a transferor and a holder of a pre-emption right), the Court said that there was a middle course by implying a duty of reasonableness and good faith in non-cash consideration offers.

it compulsory to make the offer in cash thereby making non-cash offers a breach of the terms of the agreement, or require the seller to allocate a cash consideration where non-cash consideration is envisaged[75], thereby mitigating the undesirable uncertainty.

3.1.2 Package Sale

3.1.2.1 Hypothetical Scenario and concerns

Company A wishes to sell many oil and gas interests, including its participating interest in a JOA, this latter burdened by pre-emption rights of other co-ventures. Therefore, the interest in the contract area, subject to pre-emption rights, is only a part of the properties being sold in this multi-interest sale. This company has allocated a price for the total sale, instead of pricing the individual tracts in the package.

As a consequence of this transaction's mechanic, the following uncertainties arise: Is the right of pre-emption applicable to a package sale and if so, to what extent? In other words, is the right holder entitled or forced to acquire the entire package or only the burdened portion alone? If the package sale, which includes burdened interests, does not activate the pre-emption right at all, what privilege does this right confer to its holder?

3.1.2.2 Clarification by the parties

As it has been illustrated above, the transferor offers to transfer an apparently indivisible package of assets which cannot be split. Thus, the other parties to the JOA cannot pre-empt in respect of one asset as there is no separate ascertainable consideration for that interest.

The confusions associated with package sales could easily be remedied by the parties through a clear provision in the agreement addressing the consequences and requirements of such transactions. For instance, by requiring a fair value to be apportioned to the burdened asset(s) and allowing the right holder to purchase that portion at a reasonable price. That would be a good solution, in terms of fairness and efficiency. Nonetheless, some authors hold that 'even if a prorated allocation is made, it

---

[75] Fn 54 above.

is unlikely that the resulting price will accurately reflect the true market value of the particular mineral interest'[76].

Be that as it may, if the transferor exchanging its participating interests in a JOA (as part of a wider package of non-JOA-specific assets) identifies the specific interests under the JOA and ascribes a cash value to the latters, this may preclude any ingenious suggestion from the non-transferring parties that their pre-emption rights under the JOA have given them a right to match the entire package of assets that the transferor is transferring[77].

Relevant matters for negotiation at the time of drafting the contract are whether the pre-emption right can voluntarily be extended to the other assets, thereby acquiring the whole package, or in the other way around, whether a party can be required to acquire any asset other than a participating interest. Provisions in that respect would reduce confusion about the application of pre-emption rights in this context. Nonetheless, in many circumstances, the costs of agreeing to a provision which addresses a hypothetical and remote dispute concerning the package deal outweigh its benefits[78], and as a consequence, the contract will remain silent about it.

3.1.2.3 Judicial interpretation

If nothing is said in the contract, a consistent and uniform judicial treatment of the package deal is desirable. Most decisions on the subject[79]

---

76 Conine (n 26) at p. 1321.

77 Roberts, "*Joint Operating Agreements*" (n 12) at p.159.

78 Daskal Bernard, "*Right of First Refusal and the Package Deal*", Fordham Urban Law Journal, Vol. 22, 2004. p. 1.

79 There are, however, few exceptions. *See* Crow-Spieker #23 v. Helms Construction and Development Company 731 P.2d 348 (Nev. 1987), where the Supreme Court of Nevada held that: *"[T]here was no breach of the contractual right of first refusal and that Crow-Spieker was not entitled to any relief. The rationale employed by the court was that the "terms of the right of first refusal (...) applied only to offers to purchase [the burdened property] alone. A third party's offer to purchase a package of properties was simply a different transaction from the one contemplated by the right-of-first- refusal agreement. The Supreme Court of Nevada reasoned that so long as the owner, in good faith, is only willing to sell the burdened tract as part of a larger parcel, the right of first refusal is "totally inapplicable"* in Daskal 2004 at p.473.

have held that pre-emption right provisions will apply to package sales[80] because the majority of these clauses do not expressly prohibit its application to package sales and because of the reasoning that the seller should not be able to defeat the preferential right provisions simply by transferring the burden interests along with other properties in the package[81]. However, they will differ on whether the right must be exercised against the unit interest alone or against the entire property package.

3.1.2.3.1 Towards a unit interest alone

Several Courts in United States have held that right holders may select the specific interests against which the right will be exercised[82].

In ***Brown v. Samson Resources Co.***[83], one of the parties to the JOA was willing to transfer a package of participating interest in different wells, two of them burdened by right of pre-emption. It was not disputed that pre-emption rights apply to package sales and that the right holders are not permitted to expand his right to additional properties nor required to accept additional uncovered properties. Rather, the Oklahoma Court went a step further and questioned the following: if a package sale contains interests in several wells, all of them burdened by rights of pre-emption, and other properties outside the JOA, is the right holder entitled to exercise its right to some but not all of the burdened properties?

---

[80] Cooney R. John, *"Recent development concerning Joint Operating Agreements - Preferential Rights and Exculpatory Clauses"*, 55th Annual Program on Oil and Gas Law, Institute for Energy Law of the Center for Amercian and International Law, 2004, p. 3; Sean Murphy P., *"Perspectives in Preferential Rights to Purchase in Oil ans Gas Agreements"*, p. A-12.

[81] Sean Murphy P., (n 78), at p. A-14.

[82] That was the case in McMillan v. Doole 144 S.W.3d 159, 179-180 (Tex. Ct. App. 2004), where the Texas Court of Appeal held that a holder is not required to accept other property not covered by the pre-emption right in order to exercise its right. In Navasota Resources, LP v. First Source Texas, Inc., 249 S.W.3d at 543 (2008).) and Comeaux v. Suderman, 93 S.W.3d at 221 (2002)., the Court of Appeal added that the grantor cannot require the holder of a preferential right to purchase multiple assets in addition to the burdened property, even if a term requiring the purchase of additional assets is imposed 'in good faith, commercially reasonable, and not designed to defeat the preferential right'. *See further* Maron v. Howard, (Cal. App. 1968); Humphrey v. Wood, 256 S.W.2d 669 (Tex.Civ.App. 1953, writ ref'd n.r.e.)).

[83] Brown v. Samson Resources Co. 229 F.3d 1162, 2000 WL 1234851 (10th Cir. 2000).

Brown, Huber and Samson were all parties to a JOA which covered several properties. Huber and Samson owned interests in both wells, but Brown merely owned an interest in the Cummings Well. The pre-emption right provision contained in the JOA reads as follows:

> "Should [*transferor*] desire to sell **all or any part** of its interests under this contract, ... [*right holder*] shall then have an optional prior right ... to purchase **on the same terms and conditions** the interest which [*transferor*] proposes to sell.[84]"

Hubber decided to sell many of its oil and gas leasehold interest to a third party, Coda, including the burdened properties, Cummings and Lance wells. The purchase agreement between Huber and Coda attached a schedule allocating values to the individual properties, so the purchase price could be decreased if any properties were excluded from the deal as a result of an exercise of pre-emption rights.

Samson, the party who owned interests in both wells like Huber, attempted to exercise its right as regards to one of the properties, using the value stablished in the aforementioned schedule. Hubber understood that as a breach of the pre-emption right's provision and decided to sell the whole interest in that well to Brown, instead.

The district court recognized Samson's motion based on the grounds that Huber had proposed to sell two separate and distinct interests (Cummings and Lance well respectively) and therefore, two separate rights of pre-emption were activated. However, the Tenth Circuit Court of Appeals reversed. Both courts recognized that the language in the pre-emption right provision "*to sell all or any part of its interests*" (see pre-emption provision above) only addressed the transferor, thereby giving the latter 'unfettered discretion to sell "any part of its interest"'[85]. As a consequence, Samson's preferential right was limited to the very interest Huber had proposed to sell.

---

[84] Emphasis added by the author of this paper.

[85] Brown v. Samson Resources Co. (n 82), at p.11.

Once the language was clear, the divergence between the Courts was in determining the interest that Huber had proposed to sell.

The allocation schedule attached to the purchase and sale agreement, according to the Tenth Circuit Court did not change the conditions that the right holder had to meet, which was the Huber-Coda transaction (a package sale of all the interest included). The attachment of schedule was merely in recognition that some properties were subject to right of pre-emption and others did not. These specifications did not change the fundamental character of the sale: 'Huber entered into a proposed sale of both properties together, for a listed price. In order to offer Huber the identical terms, Samson was required to match the offer (...)[86].

Since Samson could not unilaterally reduce its obligation under the preferential right provision to exercise its right to purchase, Samson was entitled to either accept or reject the offer (that Huber had proposed to sell) in its entirety[87].

The Court concluded that the seller was free to transfer the tendered properties pursuant to the purchase and sale agreement, since the offer made by him (concerning the two wells subject to pre-emption rights) was not accepted in its entirety.

3.1.2.3.2 Towards an entire property package

There are few Courts that have gone a step further from the approach in *Brown v. Samson Resources Co.,* and have recognized the exercise of rights of pre-emption towards an entire property package (which includes interests subject and not subject to pre-emption rights). This should be considered a *rara avis*, but at least two Courts in two different jurisdictions reached that decision[88].

---

[86] idem at p. 11, para 7.

[87] idem at p. 15, para 8.

[88] Capalongo v. Giles 425 N.Y.S. 225, 228 (N.Y. Sup. Ct. 1980). The Court indicated: "where an owner does have an offer from a third party to purchase a piece on which he has given a first refusal option, but on terms which specify inclusion of the piece in a larger parcel (...) he thereupon has a duty to offer the whole parcel to the option holder on the same terms". Reversed on other grounds, Capalongo v. Desch, 81 A.D.2d 689, 690 (N.Y. App. Div. 1981).

In ***First National Exchange Bank v. Roanoke Oil Co.***[89], the First National Exchange Bank of Roanoke, Virginia and R. H. Thomas (hereinafter, the Bank) owned several parcels of real estate in the city of Roanoke. The Roanoke Oil Company, Inc. (hereinafter, the Oil Company), wanted to establish a gasoline station for filling service purposes and obtained a lease of a parcel of that estate. The lease contained a pre-emption right provision, granting the lessee (the Oil Company) an opportunity to purchase the said property at the price and upon the terms of the offer received by the Lessor for the sale of the premises.

> "Eighth: If, during the term of this lease, the Lessors receive a bona fide offer of sale of the said premises, free and discharged of this lease, and desire to sell the said premises upon the price and terms of said offer, then the Lessors shall have the right to terminate this lease, provided that they give to the Lessee an opportunity to purchase the said property at the price and upon the terms of the said offer"

As soon as the Oil Company took position of the property covered in its lease, a gasoline filling station was constructed and equipped. In an adjoining parcel on the east, owned by the executors, there was a building leased to and occupied by the Roanoke Steam Laundry.

At some point during the period of the leasing, Roanoke Steam Laundry sent an offer of $20,000 cash for the purchase of both parcels (occupied by themselves and the Oil Company) to the Bank, and right after these latters sent a pre-emption notice to the Oil Company which read as follows:

> *"(...) we have received an offer of $20,000 cash for the property standing in Paul Massie's name,* ***which is occupied by the Roanoke Steam Laundry and yourselves****.*
>
> *"Clause eight of lease ... provides that the lessor shall have the right to terminate the said lease provided they give the lessee an* ***opportunity to purchase the said property at the price and upon the same terms of said offer.*** *The lessors are willing to accept the*

[89] First National Exchange Bank v. Roanoke Oil Co., 192 S.E. 764 (Va. 1937).

> *above-mentioned offer and we hereby notify you thereof. ... In the event you fail to notify us within five (5) days, this lease shall forthwith terminate and you shall be entitled to retain possession for a period not longer than ninety (90) days.*[90]"

After the receipt of this notice, the Oil Company held several meetings with agents of the Bank to discuss whether there was any possibility of splitting up of the property, whereby the Oil Company and Roanoke Steam Laundry would acquire their own parcel respectively. In light of their refusal, the officers of the Oil Company reached an understanding with a man called Johnson in order to secure their investment, whereby the latter would put up the $20,000 for the purchase of the property and would lease the filling station lot to the oil company.

The following letter was sent on July 9 to the Bank as an acceptance of the offer dated July 6:

> "The Roanoke Oil Company, hereby accepts the proposal contained in your letter of July 6, 1936, to purchase the property described therein (…), at the quoted price of $20,000 cash (…)"[91].

After the receipt of this letter, the Bank agent and the owner of the Roanoke Steam Laundry had a meeting whereby they agreed to to split the offer for the property (i.e. $8,500 for the laundry plot and $11,500 for the filling station plot). Consequently, a second offer was sent to the Oil Company, refusing the validity of the first one.

The Virginia Supreme Court recognized the validity and enforcement of the first offer on the following grounds:

> "The oil company never took the position that it could not be required to buy the entire property, or that the notice was not in accordance with the provisions of the lease. It did not say that it would or would not, could or could not, purchase on the terms offered. It did not ask any counter-proposal of the executors, but, before accepting the offer of the entire property, requested them to

[90] idem at p. 105. Emphasis added by the author of this paper.

[91] idem at p. 108.

> secure another proposal from Jones, which would permit of an alternative offer. The original offer was kept open, while waiting for the alternative proposal, and while urgent efforts were being made by the oil company to meet the original terms offered. Before the alternative proposal was received from Jones, and within the five-day period, covered in the lease, acceptance was made of the original offer. In the acceptance of July 9th, no condition was affixed, or any modification, or change made, or requested. (…) Here the executors (i.e. Bank) made a definite offer as to price, terms, and subject matter. This offer, as we have seen, was accepted without modification or change. (...) The Massie estate will receive $20,000 for the entire property, whether it be sold as a whole, or in parcels"[92].

Despite the disparity among legal authority, in transfers of interest which include multiple assets (i.e. package sales), the most likely approach, as well as reasonable, will be to allocate value to each asset such that pre-emption can be exercisable individually based on a single price for the assets that they burden[93].

It will be of most importance to set guiding terms[94] on the assessment of the interest price. Otherwise, this will usually result in a party wishing to exercise its pre-emption right, but who finds itself being defeat by an unreasonable allocation of the burdened interest[95].

3.1.3 Two-step transaction

3.1.3.1 Hypothetical Scenario and concerns

The mechanic in a two-step transaction (or affiliate route) is usually as follows: Company A, party to the JOA, transfers its participating interest to a newly and wholly owned affiliate. Under most JOAs, the transfer of assets between affiliate companies will usually not trigger the right of

92 idem at p. 113-117.

93 Sweeney (n 10) at para 10.03 [2].

94 such as the one provided –optionally- in the AIPN model form.

95 Sweeney (n 10) at para 10.03 [2].

pre-emption[96]. At a second stage, Company A sells that affiliate to a third party by way of a corporate sale.

3.1.3.2 Clarification by the parties

In order to avoid an affiliate mechanism making the pre-emption right inoperative, restrictions in that respect might be included in the clause. As regards the affiliate condition, it could be stated that such a transfer to an affiliate would be allowed, provided that this affiliate does not cease on that condition for a definite period of time. Therefore, if such affiliate ceases to be an affiliate of the transferor the expiry of the defined period, the other parties may require to go back so they can exercise their pre-emption right.

Financial capability is sometimes required even when the transaction is to take place between affiliates. If that vehicle company has no other assets at the time of the transfer, the transaction could be pre-empted by the co-venturers.

3.1.3.3 Judicial interpretation

The leading case in this matter is ***Tenneco Inc. v. Enterprise Products Company***[97]. Tenneco and several other companies[98] (hereinafter "the Enterprise Companies") owned interest in a natural gas plant that was governed by a JOA called the "Restated Operating Agreement" (ROA). This agreement granted the plant owners a right of pre-emption. At some point Tenneco Oil did the following transactions:

- Transaction (1): Tenneco conveyed its share to Tenneco Natural Gas Liquids Corporation (wholly owned by Tenneco Oil).
- Transaction (2): Tenneco Oil sold all of Tenneco Natural Gas

[96] The idea behind it is that companies should be free to re-organise their groups for many commercial and tax reasons and this, in principle, would not have a negative effect on other parties to the JOA. Gordon and Paterson (n 11) at para 14.42.

[97] Tenneco Inc. v. Enterprise Products Compan, 925 S.W.2d 640 (Tex. 1996).

[98] Enterprise Products Company, Texaco Exploration and Production, INC., Meridian and Union Pacific (from the originals El Paso Hydrocarbons Company and Champlin Petroleum Company), collectively called "the Enterprise Parties".

Liquids' stock to Enron Gas Processing Company, and Tenneco Natural Gas Liquids' name was changed to Enron Natural Gas Liquids Corporation.
- Transaction (3): Enron Gas Processing sold Enron Natural Gas Liquids' stock to Enron Liquids Pipeline Operating Limited Partnership.

The pre-emption clause in the JOA expressly allowed transfers to wholly owned subsidiaries (such as occurred in the First Transfer), which did not constitute triggering event. However, nothing regarding the second and third transactions (i.e. stock transactions) was mentioned in the clause.

The Enterprise Companies claimed that the second and third transfers invoked the right of first refusal provisions of the ROA. Tenneco and Enron Defendants contended that the second transaction (i.e. sale of Tenneco Natural Gas Liquids' stock from Tenneco Oil to Enron Gas Processing) was merely a stock sale, or in other words, a transfer of ownership in an entity, not a sale of assets or ownership interest in a plant. In addition, since it was the Tenneco Natural Gas Liquids' stock what it was transferred to Enron Gas Processing, rather than Tenneco Natural Gas Liquids' ownership interest in the plant, the transfer could not trigger any preferential rights[99].

Conversely the Enterprise Parties sustained that regardless of how the parties structured the transaction, it was, in essence, a transfer of an ownership interest. Therefore, one should look at the intent of the parties in order to determine the nature of the transaction. The Enterprise Parties based their grounds on the *Galveston Terminals, Inc. v. Tenneco Oil Co.*[100], in which the First District Court of Appeals in Houston reasoned that it was imperative to examine the substance of the transactions to determine the parties' true intent and purpose. The Court viewed the intent of the two-step process used by the seller and buyer as an attempt to circumvent

---

99 Tenneco Inc. v. Enterprise Products Company at p. 645; see p. 11, last para in this paper.

100 Galveston Terminals, Inc. v. Tenneco Oil Co. 904 S.W.2d 787 (Tex.App.- Houston 1st Dist. 1995).

the preferential purchase rights of other co-venturers, and thus, declined to recognize the transaction.

Notwithstanding the above, the Texas Court disapproved the court's reasoning in Galveston Terminals by referring to consolidated jurisprudence that come to stress that rights of first refusal and other provisions that restrict the free transferability of stocks should be construed narrowly by the courts. Hence, viewing these three separate transactions as a single transaction so as to invoke the pre-emption right provision would compromise 'the law's unfavourable estimation of such restrictive provisions[101]'.

Furthermore, the Court sustained that the plain language of the ROA provides that only a transfer of an ownership interest triggers the preferential right to purchase, not a change in stockholders. The Enterprise Parties could have included a change-of-control provision in the agreement (such as the one in the AIPN Model Form) that would trigger the preferential right to purchase, but they did not do that. The Court reminded that it is not the courts' task to 'rewrite agreements to insert provisions parties could have included or to imply restraints for which they have not bargained[102]'.

In conclusion, the purchase of stock in a corporate (that has the ancillary effect of transferring its assets) was not considered a transfer of interest in the plant, and therefore, no rights of pre-emption were triggered, regardless of the intent and purpose of the parties.

Similar results are found in different jurisdictions in the US[103].

---

[101] Tenneco Inc. v. Enterprise Products Company at p. 646, letter c.

[102] idem.

[103] In Louisiana, for instance, a two-step transaction will not trigger the right of pre-emption provided that the transaction did not take place merely to circumvent the other parties' preferential right to acquire the transferor's participating interest. Therefore, as long as there is a 'legitimate business purpose' for the first step of the transaction, the result will be the same as in *Tenneco*. See for further information e.g., Fina Oil and Chemical Company v. Amoco Production Company, 673 S.W.2d 668 (LA.App.-1st Circuit – 1996); LaRose Mkt. v. Sylvan Ctr., 209 Mich.App. 201, 530 N.W.2d 505, 508 (1995); K.C.S., Ltd. v. East Main Street Land Development Corp., 40 Md.App. 196, 388 A.2d 181, 183 (1978); Cruising World, Inc. v. Westermeyer, 351 So.2d 371, 373 (Fla.Dist.Ct.App.1977), cert. denied, 361 So.2d 836 (Fla.1978); Torrey Delivery, Inc.

This certainly is an innovative method for transferring participating interest to parties outside the JOA, without the realisation of the triggering event. Defining in detail in the agreement what activates the right of pre-emption, would reduce the cost and uncertainty associated with the exercise of such rights.

3.2 Detailed wording enhances predictability: *The Santos v Apache* case

A recent decision of the Supreme Court of Western Australia (***Santos Offshore Pty Ltd v Apache Oil Australia Pty Ltd***[104]) addressing the meaning and operation of a pre-emption rights clause in a JOA[105] illustrates how a very detailed and sufficiently clear provision enhances predictability. In the present section, the pre-emption rights clause will be analysed with the aim to show how some of the mechanics that have been studied in the above section (i.e. change in control, non-cash value and package sales) can be dealt with by the drafting parties.

3.2.1 The Spar JOA

Santos Offshore Pty Ltd ("Santos") entered into a JOA, named Spar JOA, with three other parties: Apache Oil, Apache East Spar and Apache Kersail[106] (the "Apache parties"). The Spar JOA was an agreement in relation to the operation of a joint venture to exploit the production License for the production of petroleum.

Under the Spar JOA, in the event of a proposed change in control of a party to the agreement or a transfer of the participating interest, clauses 12.2 and 12.3 confer rights on the other parties to the Spar JOA to first acquire the participating interest in question.

v. Chautauqua Truck Sales & Serv., 47 A.D.2d 279, 366 N.Y.S.2d 506, 510 (N.Y.App. Div.1975).

[104] Santos Offshore Pty Ltd v Apache Oil Australia Pty Ltd, WASC 242 (2015).

[105] Very similar to the provision contained in the AIPN 2012 form.

[106] All of the issued share capital and voting rights in these three, being held by Apache Energy Ltd.

3.2.2 Analysis of the pre-emption provision

3.2.2.1 Change in control

The thesis followed in this paper is that pre-emption rights apply to transfers of participating interest, being changes in control excluded from the triggering event. According to this statement, when the shareholding interest of a person in a party to the JOA (this latter holding the asset interest in the petroleum project) is transferred to a third party, the pre-emption right in respect of the participating interest is not activated. However, it was also indicated that pre-emption rights provisions could, nevertheless, apply to changes in control, if so is expressed in the JOA. This is what Santos and the Apache parties agreed to do when negotiating the Spar JOA.

> "Clause 12.3 (B): Any Change in Control of a Party shall be subject to the following procedure. (C) Once the **final terms and conditions of a Change in Control have been fully negotiated**, the Acquired party shall disclose the final terms and conditions (…) (D) and **each other party shall have the right to acquire the Acquired Party's Participating interest on the terms and conditions** (…)".

At one point during the life cycle of the petroleum project, Apache Energy Ltd. and Viraciti Energy Pty Ltd. entered into an agreement, by which Viraciti agreed to purchase, among others, all of the shares in Apache Energy. This transaction resulted in a change of control pursuant to clause 12.3 of the Spar JOA and therefore, the Apache parties were contractually obliged to follow the pre-emption procedure set in the provision[107].

[107] 12.3(B) Any Change in Control of a Party shall be subject to the following procedure. 12.3(C) **Once the final terms and conditions of a Change in Control have been fully negotiated**, the Acquired Party shall **disclose the final terms and conditions as are relevant to its Participating interest**, including the date of the Change in Control, and its **determination of the Cash Value of that Participating interest** in a **notice** to the other Parties. The notice shall be accompanied by a copy of all instruments or relevant portions of instruments establishing such terms and conditions and which will constitute, subject to this Clause 12.3, an offer to sell such Party's Participating interest to the other Parties. 12.3(D**) Each other Party shall have the right to acquire the Acquired Party's Participating interest on the terms and conditions** described

3.2.2.2 Package sales

One of the hindrances identified in the subsection 3.1.2 above (i.e. package sales) was whether the right of pre-emption could be extended to other assets in addition to the participating interest being transferred.

Parties to the Spar JOA, gave the following wording to clause 12.2 (F):

> "No Party shall **have a right** under this Clause to acquire any asset other than a Participating interest, nor may any Party **be required to acquire** any asset other than a Participating interest, regardless of whether other properties are included in the Transfer" or "subject to the Change in Control", in cl 12.3 (D)"[108].

This clause was read by Pirtchard J. as a limit for the transferor/acquired party from seeking to impose a condition that the other parties acquire other assets or interests, in addition to the Participating interest[109]. The jugde, quoting Chesterman J.[110] said: "Conditions of that kind (imposing co-venturers to acquire other assets) have the potential to impede the other parties to a joint venture agreement from exercising their rights of pre-emption".

On the other hand, the right of co-venturers was also restrained to merely acquire the participating interest.

3.2.2.3 Non-cash value

As regards to offers with non-cash consideration, it was observed in subsection 3.1.1 above (i.e. non-cash consideration) that it is unlikely that the terms of the offer will be matched by the right holders, when no cash value is provided in the notice.

Pursuant to clause 12.3 (F) of the Spar JOA, the right to acquire the Participating interest was a right to acquire that Participating interest 'for

---

in Clause 12.3(C) if, within sixty (60) Days of the Acquired Party's notice, such Party delivers to all other Parties a counter-notification that it accepts such terms and conditions without reservations or conditions (subject to the terms of this clause 12.3, where applicable, and other than the attainment of any necessary Government approvals) (...).

108 Emphasis added by the author of this paper.

109 Santos Offshore Pty Ltd v Apache Oil Australia Pty Ltd (n 100) at para 46.

110 in THL Robina Pty Ltd v The Glades Gold Club Pty Ltd [2004] QSC 461 [45] - [50].

cash' rather than for some other form of consideration. Therefore, where the proposed transfer was not for cash, or involved other properties, the notice was to include 'the transferor's view of the Cash Value'[111] so that each non-transferring party to the JOA could acquire such participating interest on the same final negotiated terms and conditions.

The 'Cash Value' was defined in clause 12.1(B) as the market value (in US dollars) of the Participating interest being transferred that was '*based upon the amount in cash a willing buyer would pay a willing seller in an arm's length transaction*', and was to yield the transferor the same after-tax proceeds that it would have obtained.

The cash value set out in the notice was to be deemed correct unless a disagreeing party had given notice to the transferor/acquired party, following the process set out in clause 12.3(G) of the Spar JOA. In case that no agreement was reached by the parties on the applicable cash value, this latter was to be determined by an independent expert[112].

3.3 Conclusion

When this sort of detail seen in the Spar JOA is not provided in the agreement, parties may find mechanics to avoid the realization of the triggering event (i.e. non cash considerations, package sales and two-step transactions).

It was also observed in this chapter that using standardised model forms, without any posterior negotiation among the parties involved, is

---

111 Santos Offshore Pty Ltd v Apache Oil Australia Pty Ltd (n 100) at para 51.

112 Clause 12.3(G): "The Cash Value proposed by the Acquired Party in its notice under clause 12.3(F) shall be conclusively **deemed correct unless any Party** (each a Disagreeing Party) **gives notices to the Acquired Party** with a copy of the other Parties within twenty one (21) Days of receipt of the Acquired Party's notice stating **that it does not agree with the Acquired Party's statement of the Cash Value**, **stating the Cash Value it believes is correct**, and providing any supporting information that it believes is relevant. In such event, the Acquired Party and the Disagreeing Parties shall have fifteen (15) Days in which to attempt to negotiate an agreement on the applicable Cash Value. **If no agreement has been reached by the end of the** twenty one (21) Day **period,** either the Acquired Party or any Disagreeing Party shall be entitled to **refer the matter to an independent expert** as provided in Clause 18.3 for determination of the Cash Value".

not capable of ensuring an ideal regulation. Firstly, because each and every project differs from each other and the agreement may not contemplate the specific interests of the actual parties. Secondly, because the more room for interpretation is left to the Court, the greater disparity of results is determined. Therefore, it is essential to use standard models as guides for the parties' agreement, and tailor the provisions to the extent that the governing law allows it[113], so as to meet the particular needs of the parties.

Quoting Pirtchard J.: *"Having regard to the purpose of pre-emptive rights clauses, the courts have recognised that **there is a need for caution in adopting a construction** which would restrict their operation or which would permit their application to be avoided and thus which would erode the benefit conferred by the grant of a right of pre-emption*[114]".

[113] For instance, Norwegian joint ventures are intensely subject to the terms of the mandatory Norwegian Standard JOA; in the UK, even if the parties are free to negotiate the terms of JOAs amongst themselves, pre-emption right provisions cannot be included in the JOA since the 20th round in 2002, and the previous drafted provisions have been redirected to the Master Deed form.

[114] idem at para 35. Emphasis added by the author of this paper.

4 The interference of the governing law

As the reader may anticipate at this point, drafting the contract with great degree of detail may avoid the problematic situations explained above and provide for a more predictable result when a dispute has arisen. Nonetheless, assuming that the contract will be merely applied on the basis of its own terms would be an oversimplification. A sufficiently detailed contract will not be able to prevent the external interference of the rules and principles of the governing law of the legal system where it operates.

The aim of this chapter is to illustrate the effect that the governing law may have on the construction of the contract and its interpretation. This consideration is especially important where international parties have come together in a joint venture for the purpose of a petroleum project in a particular location and a particular governing law, that might be unfamiliar to the parties, applies.

4.1 Adjusting the provision to the governing law

4.1.1 General

In the context of commercial law practice, where two or more professional parties have drafted their contract, no difficulties will often arise in case of conflict with provisions in the governing law, since the dispute will be most likely solved by applying the regulation contained in the contract, as long as the derogated rules of the governing law are not mandatory (which are a minority).

Having said that, the governing law of that particular contract will determine its interpretation in light of the desirability of ensuring a fair balance between the parties' interests, the role that the interpreter is expected to take in respect of obligations that are not spelled out in the

contract, the existence of a duty of loyalty between the parties and the extent of a general principle of good faith[115].

On a general level, parties under the common legal system are expected to spell out all obligations among themselves in detail, because the judge's function (or arbitrator's), as Cordero-Moss explains[116], is not to imply terms, consider negotiations or subsequent conducts. Fairness means predictability. Hence, a literal interpretation is desired and it is not for the judge 'to substitute for the bargain actually made by the parties, one which the interpreter deems to be more reasonable or commercially sensible[117]'. For the same reason, the judge is not expected to integrate the contract with good faith or loyalty, since that would introduce an element of discretion and uncertainty, which is deemed unattractive in business and commerce.

Contrarily, a civilian judge would interpret the contract according to its purpose and parties' intentions. In doing so, the judge would imply terms; consider negotiations and subsequent conducts, if needed, in order to reach a reasonable and fair solution, balancing the interests involved in the particular case[118].

As a result, an identical provision may be interpreted differently by a Common Law Court and a Civilian one. Even within the same legal family, there are significant differences, e.g. between the US and English law, or as it has been shown above, within the same system, there may be divergences (i.e. the same pre-emption clause may have different legal effects in the different states within the US).

---

115 Cordero-Moss Giuditta, "*Boilerplate Clauses, International Commercial Contracts and the Applicable Law*", Cambridge University Press, 2011, at p. 346.

116 in its book: "*International Commercial Contracts Applicable Sources and Enforceability*", Cambridge University Press, 2014.

117 Cordero-Moss "*Boilerplate Clauses, International Commercial Contracts and the Applicable Law*" (n 115) at p. 347.

118 Cordero-Moss Giuditta, "*International Commercial Contracts Applicable Sources and Enforceability*", (116) at p. 84-86.

4.1.2 Application to rights of pre-emption

As the reader might have observed in the previous chapter, a basic tool used by all common law judges is the wording of the contract. That is, if the parties used a particular language, its precise meaning was expected to be enforced and if the contract was silent about a specific provision, that was indeed, the parties' intention.

Most internationally distributed publications collecting model contracts in different fields such as maritime law, finance, insurance, etc. are written on a Common Law style[119]. That is the case in JOAs with the AIPN Model Forms. The Association of International Petroleum Negotiators (AIPN), being aware of the consequences that using English-based model forms might have in civil law jurisdictions, published guidance notes concerning some specific issues such as the pre-emption rights, that should be considered when using this model form.

As regards to rights of pre-emption, the Notes suggest[120]:

> "In certain Civil Law jurisdictions, pre-emption rights may result from statutory law. For instance, in some Civil Law jurisdictions, the co-owners of property and the co-holders of contractual rights may pre-empt by law transfers of any of such properties and/or contractual rights to third parties. If the Parties wish not to have pre-emption rights at all, it is advisable to include a clear *exclusion provision* in the Operating Agreement".

As a consequence of the externalization of the Common Law drafting-style practice, professional parties in different jurisdictions learn to draft international contracts on the basis of these models, which unavoidably drive the author of this paper to reflect on the following:

---

119 Cordero-Moss Giuditta, "*International Contracts between Common Law and Civil Law: Is Non-State Law to Be Preferred? The Difficulty of Interpreting Legal Standards Such as Good Faith*", The Berkeley Electronic Press, 2007, at p. 4.

120 Guidance Notes of the 2002 Model, Art. 12, at p. 5 and Guidance Notes of the 2012 model, Art. 12.2.E, at p. 6.

If the pre-emption provision drafted in detail by the parties could entail an unsatisfactory result in terms of fairness and reasonableness, would that clear clause still be enforced?

The starting point is that no harmonized approach exists between legal traditions. The approach followed by two different jurisdictions (English Law in the Common Law system and Norwegian Law in the Civil Law system) will be considered to illustrate the point, but no generalization should be made in that respect. In each specific case, the party will have to look at the particularities of each state's legal tradition.

4.1.2.1 English Law

It would be unusual for an English court to correct the wording of a contract in order to reach a fairer result. The literal meaning of the wording in the contract is mostly enforced by the judges (as long as it does not contradict the mandatory rules of the governing law), while at the same time admitting that they consider the result unsatisfactory[121]. English law is not concerned with the motive behind why parties act as they do[122], often exemplified with the Latin expression *caveat emptor,* which comes to stress that every party should take care of their own interests, and not expect the other to do that.

Fairness in this context stands for predictability. Therefore, by giving effect to the reasonable expectations of the parties, the objective requirement of good faith is achieved[123]. For a common law interpreter, a fair solution would be that one enforcing the provisions voluntarily drafted by the parties[124].

---

121 ibid at p. 7.

122 Clarke Mark and Cummins Tom, "*Governing law and dispute resolution clauses in energy contracts*", Ashurst London briefing, 2011, at p. 1.

123 Steyn Johan, "*Contract Law: Fulfilling the Reasonable Expectations of the Honest Men*", 113 L.Q.R., 1997, at p. 446, 450.

124 Clarke and Cummins (n 122) at p. 1.

4.1.2.2 Norwegian Law

Under the Norwegian system, such a clause would be interpreted in accordance with the parties' objective intention[125], but the wording of the contract would be supplemented by principles of good faith and fair dealing. This is often referred to as the 'Nordic rule on reasonableness' (in coordination with other Scandinavian countries). According to this rule, a Norwegian Court would, contrarily to an English Court, but similarly to any other civil judge, interpret the contract in light of good faith and would correct the literal interpretation of a contract to avoid an unfair result.

In addition, and differing from other civilian judges' role[126], a Norwegian Court would even go a step further and 'would correct the wording of the contract to achieve a better balance of interest between the parties, even if the contract regulation did not lead to unfair results[127]'.

4.1.3 Conclusion

The conclusion in Chapter II was that special attention should be placed in the drafting process in order to reduce uncertainty in future disputes and guide the Court to reach the desired result. However, as it has been explained here, the wording of the contract cannot be detached from the governing law where the contract operates and the legal tradition of the final interpreter. That is to say that, even when the parties have spent long hours negotiating and have finally included detailed provisions in their contract, which regulate each and every controversy that it is likely to

---

[125] Cordero-Moss Giuditta, "*International Contracts between Common Law and Civil Law: Is Non-State Law to Be Preferred? The Difficulty of Interpreting Legal Standards Such as Good Faith*" (n 119) at p. 15.

[126] idem.

[127] ibid at p. 15, where she exemplifies it with the following case: "*In a long term lease agreement between a landlord and a mining company, for example, the Supreme Court interpreted a clause that gave the mining company the option to renew the lease for a further period "at the same conditions", as if the landlord was entitled to renegotiate the price (and this in spite of the fact that the contract contained a clause for the indexing of the price, therefore providing for an automatic adjustment of the price and avoiding gross unfairness*".

occur, they can not mistakenly believe that their contract is self-sufficient or tend to 'elevate the contract to the level of law'[128]. Hence, a key element to take into account by the parties is the legal tradition where the JOA will operate and draft the contract accordingly.

4.2 Government's rights of pre-emption

It has been explained that pre-emption rights are a mechanism that parties to a JOA may use to restrict transfers of interest under a license, and therefore it is critical for the party that wishes to transfer its participating interest to consider these rights together with co-venturers and potential buyers. As this section will show, there might be other third parties' consents or waivers required in order to complete the transaction i.e. the government's pre-emption right. It will be essential to understand the specific political landscape where the project is developed and the impact that the acquisition might have, as a foreign investor.

Three different jurisdictions will be analyzed, namely: Kazakhstan, Angola and Norway, through their regulation in transfers of interest and change of control[129] and experiences that each state has with pre-emption rights will also be commented.

4.2.1 Kazakhstan

4.2.1.1 Regulation

The regulation of exploration and production of oil and gas in Kazakhstan is mainly contained in the Law of the Republic of Kazakhstan No. 291-IV, dated 24 June 2010 'On Subsoil and Subsoil Use' (hereinafter "the Subsoil Law"), amended by the No. 271-V 'On the Introduction of Amendments to Some Legislative Acts of the Republic of Kazakhstan on Subsoil Use Issues', signed on 29 December 2014 and in force since January 2015.

128 Cordero-Moss Giuditta, "*Boilerplate Clauses, International Commercial Contracts and the Applicable Law*" (n 116) at p. 348.

129 For the purpose of Chapter IV, no difference will be made between transfers of interest and change of control, except when deemed necessary.

It should be noted that a new Subsoil Code is being developed at the moment and it is expected to be enacted during 2016.

The Subsoil Law regulates the full range of upstream oil and gas activities, as well as the procedure for granting subsoil use of rights, the termination and requirements for transfers of such rights, among others.

As regards to transfers of subsoil use rights and objects connected therewith, the Subsoil Law prescribe in its Article 36 certain restrictions and requirements that the parties will have to comply with.

The first paragraph of Article 36 spells out a list of different scenarios that could entail a transfer of subsoil use rights and objects related to subsoil use right. The wording "objects related to subsoil use rights" stands for participating interest or shares in a legal entity holding subsoil use rights, as well as interest in a legal entity that has the power to directly or indirectly determine the decisions and or influence decision of subsoil used, if the main activities of such legal entity are connected with subsoil use in Kazakhstan[130]. When one of this scenarios is to take place (without differentiating whether it is an oil or gas field with strategic importance, and the relevance of this will be shown below), the parties must obtain the consent of the Ministry of Energy before the completion of the transaction[131]. If the transaction is completed without the aforementioned consent, the Ministry of Energy can unilaterally declare the transaction invalid. It is also important to mention that Article 37.10 states that subsoil use rights (such as direct interests in a subsoil use contract) for petroleum may not be transferred within two years from the date of signing the contract, subject only to limited exceptions (e.g. the transfer or acquisition of subsoil use right to national company or its subsidiaries).

Article 12 recognizes the right of pre-emption that the government has to acquire subsoil use rights with respect to oil and gas fields, however, with the last amendment, only those which are considered to be "deposits of strategic importance", and objects connected with the latters. The

130 Zhaiylgan Almas, Kenjebayeva Aigoul and Albanov Nurzhan, "*Energy: Oil & Gas 2016 Kazakhstan*", Chambers Global Practice Guides, 2016. Available at: <http://www.chambersandpartners.com/guide/practice-guides/location/271/8244/2357-200> last accessed 19 June 2016.

131 This consent is to be issued within the next 20 days.

government has adopted a list with the deposits with strategic importance, which includes the Karachaganak and Kashagan fields.

The priority right extends to vis-à-vis other contracting parties or parties to a legal entity possessing the right of subsoil use, and other persons to acquire (either on compensated or gratuitous basis): 1) the direct interest in a subsoil use contract (subsoil use right); 2) objects associated with the subsoil use rights.

Last paragraph of Article 12, by referring to the cases covered by Article 36.5, prescribes few exceptions to the application of this right. These exceptions include, for example, transactions concluded on a stock exchange, provided that the relevant consent from the competent authority has already been obtained for the listing of stocks (Article 36.5.1) or transactions between 99.9% affiliated entities (Article 36.5.2), when these affiliated entities are not registered in a state with preferential taxation system (i.e. offshore jurisdictions).

The procedure for implementing pre-emption rights by the state is regulated in Article 13. The State can exercise its right of pre-emption either through a national management holding company, a national company or an authorised state body. Obtaining the waiver of the state from its priority right under the law requires 50 business days.

4.2.1.2 Experience with pre-emption rights

In March 2003, CNOOC (China National Offshore Oil Corporation) announced its intention to buy a 16.67% stake in the North Caspian Sea Project from Britian's BG Group US$1.23 billion. Western partners, including ENI, ExxonMobil, Royal Dutch/Shell, Total, ConocoPhillips and Inpe, could have pre-empted CNOOC's purchase by offering the same price to BG within 60 days from the offer, but decided not to, since they had good experience working with CNOOC on other projects. Contrarily, the government of Kazakhstan, wishing to increase its interest in the project, refused to approve the transaction. The reasoning behind its action was that, since the government owned all subsoil rights, it also

had a pre-emptive option to acquire it[132]. Right after, Law No 2-III was introduced to amend Article 71 of the Law on the Subsoil and Subsoil use:

> "*With the aim to preserve and strengthen the reserves and power resources of the economy in new and existing contracts for subsoil use the State* ***shall have a pre-emptive right*** *over any other party to the contract or participants in a legal entity having a subsoil use right, or other persons to buy an alienated subsoil use right (or part thereof), or part of a share (stockholding) in a legal entity having a subsoil use right, on the conditions not worse than those offered by other buyers*".

The change was regarded as 'highly controversial' because it allowed the government to pre-empt any sale of subsoil use rights, even where this had not been incorporated in the original contract[133]. The Kazakhstan Petroleum Association said that this new law would "undermine investors' confidence in the republic's commitment to providing a stable and predictable legal and contractual regime"[134].

After extensive negotiations, an agreement was reached whereby Kazmunaigaz (the state-owned oil and gas company, hereinafter KMG) acquired half of the BG Group's in the project (8.33%), while the other half was split among the other consortium members.

This mechanic has been repeated during the following years. For instance, in 2012, ConocoPhillips announced that it had reached a deal to transfer 8.4% stake in Kashagan to India's ONGSC Videsfh for US$ 5billion. Nonetheless, the government exercised its pre-emption right to block the transaction and Conoco's share in Kashagan was sold to the state-run company KMG, one year later being transferred to CNPC (China National Petroleum Co) for the same price. At that time, China had already emerged as a major investor in the Kazakh oil sector, having invested US$30billion in a 2013 visit in Kazakhstan.

---

132 Overland Indra, Kjaernet Heidi and Kendall-Taylor Andrea, "*Caspian Energy Politics: Azerbaijan, Kazakhstan and Turkmenistan*", Routledge, 2010 at p. 128.

133 ibid.

134 ibid.

As these experiences show, pre-emption rights also become highly political tools that governments use for different reasons, such as to prevent the entrance of foreign investors.

4.2.2 Angola

4.2.2.1 Regulation

The main Angolan law regulating the activities of the oil sector, such as prospection, search, development, concession, among others, is the Law No. 10/04 of 12 November 2004 "Petroleum Activities Law" (hereinafter "PAL"). This act recognizes in its preamble the fundamental principle stated in the Constitution, whereby the Angolan State is the owner of the petroleum resources and the regimes of a sole concessionaire and mandatory association for petroleum concessions.

The national concessionaire, "*Sociedade Nacional de Combustíveis de Angola*" (hereinafter, Sonangol), is, according to Article 4 PAL, the holder of the mining rights and has the competence to conduct, execute and ensure oil operations in Angola.

Article 16 of the PAL regulates the transfers of interest under the heading "assignments". First paragraph establishes that the associates of the National Concessionaire (i.e. Sonangol) may only assign part or all of their contractual rights and duties (including the transfer of shares and participations to third parties representing more than 50% of the share capital of the assignor) to third parties of recognized capacity, technical knowledge and financial capability, after obtaining the prior consent of the supervising Minister (i.e. Minister of Petroleum), which must be published in an Executive Decree.

Nonetheless, when there is a transfer between affiliated companies, provided that the assignor remains jointly and severally liable for the duties of the assignee, the transaction will not be subject to the aforementioned Minister authorization.

In both cases, the approval of Sonangol will be necessary. In addition, the latter has a right of pre-emption (namely "right of first refusal") when a transfer of contractual rights to third parties occurs, unless such rights

are assigned to an affiliate of the assignor. However, if Sonangol decides not to exercise its right of first refusal, the latter will be immediately transferred to the National Associates[135], which enjoy the special status of "national company" and have been granted in specific rights and duties (Articles 16.3 and 31.3 PAL).

4.2.2.2 Experiences with pre-emption rights

In October 2008, China Petroleum and Chemical Corporation (SINOPEC) and China National Overseas Oil Company (CNOOC) negotiated with US Marathon Oil Corporation (Marathon) and agreed to buy a 20% stake in Angola's offshore deep water block Block 32 for $1.3 billion[136]. However, in October 2009 Sonangol decided to exercise its right of first refusal and announced its intention to acquire it, being the Chinese purchase blocked. The sale was finalized in February 2010[137].

Sonangol did not offer a full account of its grounds but some issues had caused rejection over the Chinese investment. In 2004 SINOPEC was involved in negotiations with the Angolan government to develop a huge oil refinery (Sonaref) at Lobito, which was, at that time, a key target for the government. The deal was nevertheless called off because of a disagreement between the parties concerning the size of the refinery and the destination of the refined product (Beijing wanted the oil in China). Some reports suggest the disinclination in Angola over the Chinese participation, considered a latercomer that lacked expertise for ultra-deep-water drilling[138], and which involved the presence of 'low-skilled and temporary workers and shopkeepers'[139].

---

135 Art. 2.3 of the PAL: "*National Associate – a corporate entity which is formed under Angolan law, with registered office in Angola which in such capacity associates itself to the National Concessionaire in any of the forms set forth in Article 14, paragraph* 2".

136 Shinn H. David and Eisenman Joshua, "*China and Africa: A century of Engagement*", University of Pensylvania Press, 2012 at p. 341.

137 More about it in: Gadzala W. Aleksandra, "*Africa and China: How Africans and Their Governments are Shaping Relations with China*", Rowman & Littlefield Publishers, 2015; Shinn and Eisenman (n 137).

138 Shinn and Eisenman (n 136) at p. 341.

139 ibid at p. 342.

4.2.3 Norway

4.2.3.1 Regulation

The main regulations concerning the petroleum activities in Norway are the Petroleum Act of 29 November 1996 No 72 (hereinafter "the Petroleum Act") and the Regulations of 27 June 1997 No 653.

The state participates in the license and the corresponding joint venture in the same way as any other licensee and participant. According to Section 11-1 of the Petroleum Act, the state reserves a specified share of a license and in the joint venture established by the Joint Operating Agreement in accordance with the license.

To directly or indirectly transfer a license or participating interest in a license, the approval of the Ministry is required (Section 10-12). In special cases, the transfer will be subject to a fee.

Pursuant to the standard JOA[140], a party may assign its participating interest or a part thereof. However, when the obligatory work commitment has not yet been carried out, transfers of participating interest or part thereof to others than an affiliated company will require the consent of the management committee.

Under clause 23.2 of aforementioned JOA, the state has a pre-emption right in the event that other participants agree to assign their participating interests (except for those assigned to an affiliated company)[141]. If exercised, the state has to acquire the participating interest at the agreed price and terms with the buyer (in that respect, a party may include a clause in the assignment agreement to the effect that the agreement will be terminated if the pre-emption right is exercised[142]). The notice of exercise of the pre-emption right is due no later than 40 days after the receipt of the notification.

---

140 <https://www.regjeringen.no/globalassets/upload/oed/vedlegg/konsesjonsverk/k-verk-vedlegg-1-2-eng.pdf> last accessed 19 June 2016.

141 Artikkel 23 (Overdragelse av deltakerandel) "(…) 3. Forretningsføreren]/[Staten, ved Departementet,] kan overta hele andelen til den pris og vilkår som er avtalt (…)".

142 Standard Joint Operating Agreement, 23.3, para 3.

4.2.3.2 Experiences with pre-emption rights

As far as it is known, the state has never exercised its pre-emption right. There is no clear explanation for this, but practitioners seem to be of the idea that there simply had not been a need for it and possibly that the cost would be too high. They also argue that Norway already has a lot of revenues from the oil industry in form of taxes, thus there is no need for these rights to be on the table. This gives the impression that rights of pre-emption have the primary purpose of securing and optimizing monetary assets that may only be ultimately exercised if there is a sporadic and exceptional need.

4.2.4 Conclusion

This section pointed to an additional risk that actors are exposed to. Transferors and potential buyers will sometimes be not only subject to the consents or waivers of the other parties to the JOA, but governments. There are multiple factors directly and indirectly connected to political rights of pre-emption. The most visible are the commercial and political interests of the governments in the contract area.

Norway is a neutral political state that has been consistent with the idea that there is little need to interfere in the industry through politics. They may have other ways to meet their interests, for instance, placing a strong focus on the licensing system. From an economic perspective, there is no need either to secure the national interests through the exercise of these rights, since the tax system already serves this purpose. However, one could assume that if there was a serious economic reason (e.g. the value has heavily increased) or a critical political situation involved (e.g. a potential player with a very bad reputation), the state has this right, as a safeguard tool, in order to not be left behind.

By contrast, the tendency in developing countries shows that governments have less concerns in interfering in the industry, both for political reasons (e.g. preventing the entrance of an unwanted foreign investor) or commercial reasons (e.g. increasing the state participation in the contract area).

In sum, in some developing countries e.g. Angola and Kazakhstan the uncertainty might be higher as compared to developed countries such as Norway, which might be explained due to the greater political stability in the latter.

Be that as it may, it is critical for the parties and more specifically, as a foreign investor to consider the particular political landscape where the project operates and the risks associated with the exercise of pre-emption rights in that specific context, and decide early on in negotiations who will bear the cost of such government's waivers and consents.

5 Conclusion

The research conducted in this paper was meant to explore critical aspects related to pre-emption rights in the context of transfers of interest within petroleum projects. The author believes that by identifying specific issues early in stage, the transfer process will be simplified, both in terms of time and expense, and the transaction successfully closed.

One of the core aspects that has been highlighted is the importance of the drafting process of pre-emption provisions.

A transfer of upstream interest is a very sensitive issue within the life cycle of a petroleum project. Parties, at the time of disposal, might disagree and in last instance, it will be for the judge or arbitrator to interpret the contract. If special attention is placed in the drafting process, uncertainty in future disputes will be mitigated and the wording will possibly guide the interpreter to reach the desired result.

In addition, it is important to understand that each upstream project has its singular characteristics; hence, the parties should adjust each provision to meet their specific needs. Using model form's clauses without any further negotiation between the parties is not desirable and leaves the parties with a high degree of uncertainty. As explained in chapter three, several scenarios are likely to occur, such as a package sale, a restructuring transaction or an asset swap, that might render the pre-emption mechanism being circumvented. If that is not the original intention of the parties, a clear wording to that respect would favour their intentions.

All in all, drafting the contract with great degree of detail may avoid the problematic situations explained above and enhance predictability, as it was observed in the Santos v. Apache case.

Nevertheless, the insistence of the author on the importance of a clear and detailed language cannot lead to assume that the contract will be merely applied on the basis of its own terms, since that would be an oversimplification. A sufficiently detailed contract will not be able to prevent the external interference of the governing law applicable to the contract. The first section of chapter four illustrated the most

distinguished differences between common law and civil law systems as regards to the interpretation of the contract, which is also an essential element to be considered by the parties.

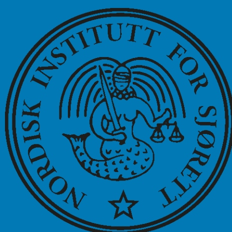
Finally, pre-emption rights are not merely a tool that parties to the JOA can use to restrain the transferability of participating interests, resulting, if exercised, in an internal economic reallocation of interests between the non-transferring parties, but also a right that is sometimes granted to governments. Therefore, as a potential foreign buyer, having a broad understanding of the political landscape where the project is being developed is critical, particularly in terms of risk allocation; the mere knowledge of this risk will leave room for discussion on who will bear the cost of such government's waivers and consents.

THE SCANDINAVIAN INSTITUTE OF MARITIME LAW is a part of the University of Oslo and hosts the faculty's Centre for European Law. It is also a part of the cooperation between Denmark, Finland, Iceland, Norway and Sweden through the Nordic Council of Ministers. The Institute offers one master programme and several graduate courses.

The core research areas of the Institute are maritime and other transport law as well as petroleum and energy law, but the members of the Institute also engage in teaching and research in general commercial law.

In MARIUS, issued at irregular intervals, articles are published in the Nordic languages or English.

ISSN: 0332-7868



07 Media